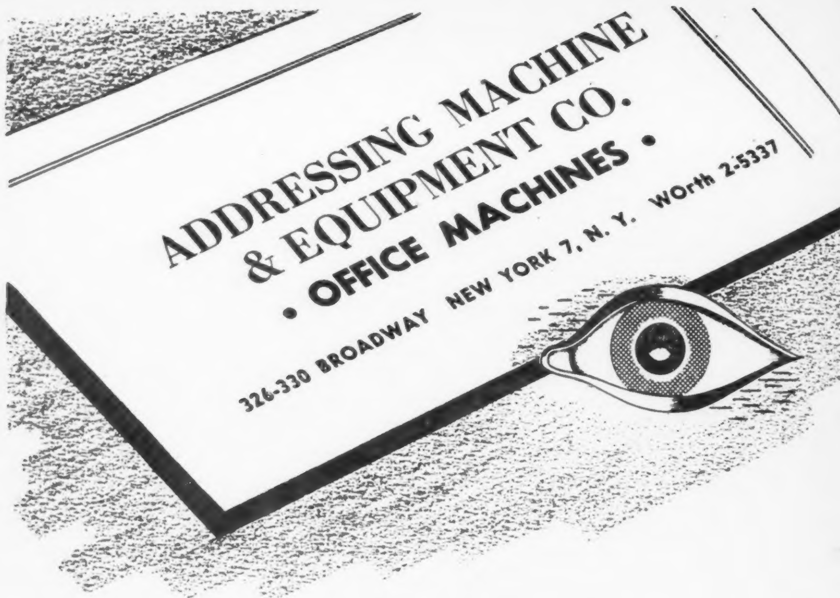
The New York Certified Public Accountant

VOL. XVII *February · 1947* No. 2

Published Monthly by
THE NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS
15 E. 41st STREET : NEW YORK 17, N. Y.
Single Copy 35 Cents — One Year $3.50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THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT

EMANUEL SAXE, *Managing Editor*

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Excerpts From the Addresses Delivered at the Society's December Meeting on Current Problems in New York State Taxation

ON December 9, 1946, the Society's regular monthly meeting was conducted under the auspices of our Committee on State Taxation, with chairman J. B. C. Woods presiding. The guest speakers, representing the New York State Department of Taxation and Finance, were: Spencer E. Bates, Commissioner of Taxation and Finance and President of the New York State Tax Commission; George B. Klein, Deputy Commissioner and Director of the Income Tax Bureau; and Benjamin B. Berinstein, the Department's Manhattan District Supervisor.

Space does not permit the full reporting in these columns of the excellent and instructive addresses delivered by these gentlemen, but the following excerpts therefrom will serve to highlight their talks.

Commissioner Spencer E. Bates: While all of the tax laws are of concern to you, I presume that your major interest lies in the corporate franchise tax under Article 9-A. Some observations concerning this newest of our tax statutes—how it is working out—may therefore be pertinent. I can report that the new law appears to be generally satisfactory. It has been accepted, almost without reservation, by the taxpayers as an important forward step toward greater equity and tax justice. Our studies have shown that while there may have been some individual fluctuations in tax, downward or upward, the over-all effect on State revenues has been small, and the individual variations have been substantially justified on the ground of fair treatment and tax equity.

There seems to be no question but that the new business allocation formula represents a decided improvement over the old, primarily because it eliminates property as the main control and uses three factors with equal weight. A survey now under way but as yet incomplete appears to indicate clearly that the new allocation formula, employing an average of three percentages, does not create as many wide variations between individual companies as the old formula based solely on average monthly dollar values. Nevertheless, we do not even now claim perfection for the new law. That was not claimed when it was first placed into effect and, even after various changes and adjustments which have already been instituted, the Commission still does not consider the law a final or fixed document. We are continuing our studies of its practical effect and shall continue to improve its structure as opportunity for improvement develops.

As an example of how the law and regulations implementing it are subject to change, I may cite two recent impor-

tant rulings of the Commission relating to discretionary adjustment of the business allocation percentage. The Commission ruled, first, that it would, upon application of the taxpayer, eliminate the property factor in the business allocation percentage and substitute as a third factor the percentage which the taxpayer's business expenses (other than salaries and wages), incurred or expended with New York, bore to the total of such expenses within and without New York, in the event that: (1) the corporation is entitled to an allocation of its business income and capital; (2) the corporation owns no real property, either within or without the State; and, (3) the corporation's ownership of tangible personal property within and without the State is comprised solely of furniture, fixtures and other office equipment.

The ruling provided, moreover, that in the case of any corporation fitting the circumstances outlined, the Commission may make a discretionary adjustment by eliminating the property factor on its own motion.

This ruling, which we refer to as Ruling #1, will permit realistic treatment of certain corporations where the circumstances would have produced a distorted tax result. I call your attention especially to the procedure which has been established for making application for this discretionary adjustment. The ruling provides that the applying corporation must annually file its report and calculate its business allocation percentage, using the statutory formula; it must attach a rider to the report setting forth the items and value of all property owned by it, and the items of its business expenses (other than salaries and wages) incurred or expended within New York, together with the items of such expenses incurred or expended within and without New York. In the case of reports already filed, taxpayers may apply for this adjustment by supplying the required information in an affidavit executed by an officer of the corporation. Of course, this is subject to any statutory time limitation.

A second ruling, which will doubtless have limited application, provides for an adjustment of the business allocacation percentage affecting any corporation which qualifies under these five points:

1. Maintains its principal executive office and a sales office in New York.
2. Manufactures outside New York all of the products which it sells.
3. Owns a factory or factories none of which are located within New York.
4. Receives and accepts orders within New York for the sale of its products in excess of 80% of its total gross sales.
5. Fills such orders to the extent of at least 60% thereof by deliveries from public warehouses located both within and without New York which are regularly and continuously used and occupied by the corporation, and fills the balance of such orders by deliveries from permanent and continuous places of business maintained by the taxpayer.

The Tax Commission will, upon application of corporate taxpayers qualifying for this particular adjustment, eliminate the receipts factor in the business allocation percentage and substitute as a third factor the percentage which the rental costs of the public warehouses in New York bear to the rental costs of the public warehouses both within and without New York. As in the case of Ruling #1, the Commission may make a discretionary adjustment, under this second ruling, on its own motion. Procedure for applying for the adjustment under Ruling #2 is similar to that which governs Ruling #1.

* * *

You will be interested to know that we are currently revising our regulations for Article 9-A. They are being

brought up-to-date to cover amendments to the law, new rulings, and to clarify certain articles in order more accurately to reflect administrative interpretations. At the same time, obsolete material is being eliminated, including articles relating to the now-completed interim tax period which had bridged the gap between the old law and the new.

The new regulations, which will soon be promulgated to become effective on or about December sixteenth,[1] cover such items as:

1. The amendment made by the 1946 Legislature permitting certain affiliated corporations to file a combined report, rather than a consolidated report.
2. The Commission's interpretation of the law permitting a corporation to allocate its income in and out of the State if it has a regular place of business outside New York, even though it has no employees at such place of business.
3. The amendment which allows January and February fiscal-year companies four months in which to report, so that January companies now have until May 31 and February companies until June 30, whereas their reports have previously been due May 15.

In addition to the various corrective and clarifying changes, the new regulations will include further illustrations of corporations which are exempt from the tax because they are exclusively engaged in foreign or interstate commerce.

From a revenue standpoint, as I indicated earlier in reviewing current tax receipts, the corporate franchise tax is meeting every test.

Some of the uncertainty concerning corporate tax revenue revolves around two factors: renegotiation of war contracts and accelerated amortization of war facilities. You may be interested to know that as of September 30, this year, over 21 millions of dollars had been granted to corporate taxpayers in abatements, credits or refunds resulting from the renegotiation of Federal war contracts dating back to the base year 1941. Some of these cases are still pending. The effect on our revenues of the accelerated amortization of war facilities cannot be accurately appraised at this time, but will undoubtedly be substantial. In this connection, I should like to point out that it is the policy of the Commission to make no adjustment on a tentative allowance of increased amortization. The Commission will make such allowances only after the Internal Revenue Bureau has made its final determination in each instance.

Addendum by Chairman J. B. C. Woods: Another point for which we are particularly grateful to Commissioner Bates is that, for a number of years, your Committee on State Taxation has been trying to effect a change in the law which would make it possible for a real estate corporation which is on a fiscal-year basis to use its income statement and annual balance sheet as a basis for reporting on Form 42-CT, the State Franchise Tax Return for Real Estate Corporations. We didn't get that change in the law; but this year, shortly after Commissioner Bates assumed his present position, we were able to get the substance of what we were seeking, not by a change in the law but by a change in administrative procedure. Those of you who have had the trouble of converting real estate corporation income statements from a fiscal to an annual basis in order to make a report, will be saved that trouble in the future. We owe that to Commissioner Bates by reason of his knowledge of the needs of taxpayers and what can done in the Department.

Deputy Commissioner George B. Klein: I will now touch on the work of our Refund and Revision Section.

[1] Regulations 9-A (1947) were duly promulgated on December 16, 1946, but may not be ready for distribution until February 15, 1947.

In this unit, all cases are referred where Forms 113, Claim for Revision or Refund, or Form 114, Demand for Hearing, are filed. Under Section 374 of the Tax Law, Form 113 may be acted on if filed within two years from the date of filing the return, or if the tax has been recomputed within one year from date of recomputation.

Before going further in this matter, I would like to refer back to the Special Assignment Section where informal protests are handled. A letter of protest does not protect the taxpayer's rights and, if an adjustment is not made within one year from date of the assessment, any adjustment may be barred under the Statute of Limitations. If you find that your correspondence is not receiving attention and the one-year period is expiring, a claim on Form 113 should be filed to protect your client's rights.

When Form 113 is received, the file goes direct to the Revision Section where a card is prepared. This card carries a record of the case from that point to completion. Here the examiner reviews the claim with all information included thereon and any correspondence received prior thereto. If the evidence permits an adjustment, refund is authorized, or, in the case of an adjustment of tax, the cancellation in whole or in part is entered. Correspondence may be continued or the claim denied. If the claim is denied, you must file demand for hearing on Form 114 within 90 days from the date of the denial. On receipt of this claim, the taxpayer is usually advised to review the case at a preliminary hearing. This is a very informal procedure, although minutes are taken, and, after a review, the taxpayer is notified of any adjustments which will be permitted. If an adjustment is allowed in part, he is so advised and requested to withdraw his application for formal hearing or to notify us if he wishes to proceed to the formal hearing. Most of our cases are closed at the preliminary hearing and about 5% go to formal hearing. I wish to state here that if the cases were better prepared when going to the preliminary hearing, many more could be closed without a formal hearing. Many people come without any facts and believe they can talk their way out.

The formal hearing, as its title indicates, is a more formal procedure. The taxpayer or witness testifies under oath and all claims must be supported by evidence. Much time is lost at these hearings because the taxpayer's representative fails to have evidence to support his claims. In some cases he does not have the taxpayer appear, which is necessary in most instances. All evidence must be put in the record, whether submitted previously by correspondence or not. Only evidence presented at the hearing is considered in making the determination. When the minutes are transcribed, a formal determination is drawn up and signed by the Commission. If the determination is against the taxpayer, the only step open is a review in certiorari. Notice for review must be filed within thirty days after the date of notice of the determination.

The preliminary hearings and the formal hearings are held at the district offices, mainly in New York City, for the accommodation of the taxpayer and his representatives. The calendar is set up periodically and the taxpayer notified as to the time and the place of the hearing. In the case of preliminary hearings, a member of the New York office contacts the various taxpayers or their representatives in an attempt to find a date which is to their convenience. In the case of a formal hearing, the calendar is set up from Albany and the accountant or attorney is advised as to the time and place of the hearing. These hearings outside of the main office cost considerable money and take up a good part of the time of our more capable employees. However, each week that a calendar is arranged, we find that many of the taxpayers or their representatives fail to make an appearance. This condition is becoming so prevalent that we now find it necessary to increase the number of hearing

calendars. This is particularly true with reference to formal hearings. Recently a special letter has been sent to the attorney or accountant advising that, unless an appearance is made or an explanation for the postponement is received with good reasons why they are unable to appear, the hearing must be held in Albany. You can readily understand that, where a time has been alloted for a hearing which we estimate would take two to three hours, it is a costly practice to send highly trained men to New York to sit around a half a day awaiting for their next appointment. The Department will be fair and, where a reasonable excuse is received, grant a postponement. However, in such cases, the representative should notify the Department immediately upon receipt of the notice of the hearing. This will at least give us time to make a substitution. If taxpayers fail to appear for a regular calendar in New York and a second appointment is made for a hearing in Albany at which the taxpayer again fails to make an appearance, the Department will draw a determination in default.

District Supervisor Benjamin B. Berinstein: I cannot refrain from calling your attention to a forward step in taxation that is now being fulfilled as the result of much effort on the part of Commissioner Bates. Many of the corporations doing business in New York State, as you well know, are also doing business in other States and may be adversely affected, tax-wise, by reason of the many differences in the statutory basis for effecting allocations and segregations of assets in the several States. I can well visualize, in an exceptional case, that an entity doing business in a number of States—all such States levying franchise taxes—might, under a given set of circumstances by reason of the differences in the statutes referred to previously by me, become liable to a tax base in the aggregate, for purposes of franchise taxation, in excess of 100% of taxable income.

As you know, the National Association of Tax Administrators is made up of the taxing officials and authorities on taxation drawn from every State in the union. Commissioner Bates heads its Committee on Cooperative Audits. It is proposed, through the medium of a central agency sponsored by the Association and with the approval of the State taxing authorities in every State that desires to become a party to the plan, to exchange information dealing with the activities carried on by a subject corporation within the confines of a given State, the amount of tax for which it has become liable, and the factors taken into consideration in determining that liability.

I say to you frankly, it is my thought that this exchange of information is only the starting point. Much more lies ahead to be accomplished. It is not too difficult to visualize, however, that if all of the States in which your taxpayer corporation is doing business have a component picture of the aggregate tax obligation the corporation defrays, there has been created the ground-work for what may ultimately result in uniformity in the taxing statutes of the several States in relation to the allocation and segregation of assets, to the extent that an undue tax burden such as I have previously discussed may eventually be eliminated. This type of thought constitutes wholesome tax administration.

The Allocation Formula as a Factor in the Determination of the Form of Business Organization

By Ralph G. Ledley, C.P.A.

With the recent decrease in federal corporate taxes, many small and medium size organizations, which have been operating either as sole proprietorships or partnerships, are seriously considering the desirability of becoming corporations. There are many factors to be considered in making such a decision.

Most of the factors are non-tax factors and are therefore within the province of the businessman himself to evaluate. The accountant, acting as a business consultant, should give his client the benefit of his advice, but the final decision as to the weight to be given to such factors must rest with the client himself. Tax factors, however, are within the particular province of the accountant and it is he who must bring them to the attention of the client.

Ralph G. Ledley, C.P.A., is a tax specialist, and a member of the faculty of Queens College in New York, N. Y. He was graduated from Columbia College in 1932 with a B.A. degree, from Columbia Law School in 1934 with an LL.B. degree, and from the Columbia School of Business in 1935 with an M.S. degree. He was admitted to the New York Bar in 1935 and received his C.P.A. certificate in 1936. He has been a member of our Society since 1936 and is presently a member of the Committee on State Taxation. He is also a member of the Association of the Bar of the City of New York and of the Queens County Bar Association, serving as a member of the Committee on Taxation of the former, and as Chairman of the Committee on Taxation of the latter.

One factor to which very little weight has been given in the past is the question of the difference between the allocation formulae prescribed in the various New York tax laws. The decision as to whether to continue in the unincorporated form or to change to the corporate form should, in certain instances, be based very largely on the amount of tax which will be paid to the State of New York either under the Corporate Franchise Tax Law (Article 9A) or under the Unincorporated Business Tax Law (Article 16A). Prior to the enactment of the new article 9A in 1944, the difference was even more important than it is today, but it still possesses sufficient importance to warrant at least passing attention on the part of the accountant.

It should first be noted that in order to entitle the taxpayer to make an allocation for purposes of the Unincorporated Business Tax, it is only necessary that the business be "carried on both within and without the state," while the Franchise Tax Law requires the taxpayer to "have a regular place of business outside the state other than a statutory office" before an allocation applicable to business income may be applied.

The allocation factors presently in effect are found in section 210, subdivision 3, of the Tax Law for the Franchise Tax, and in section 386-g thereof, for the Unincorporated Business Tax. The New York factors for the allocation of business income in the case of the Franchise Tax are:

1. "The average value of the taxpayer's real and tangible personal property within the state."

2. "The receipts of the taxpayer . . . arising . . . from (A) sales of its tangible personal property located within the State at the time of the receipt of or appropriation to the orders, (B) sales of any such property not located at the time of the receipt of or appropriation to the orders at any permanent or continuous place of business maintained by the taxpayer without the state, where the orders were received or accepted within the state, (C) services performed within the state, (D) rentals from property situated, and royalties from the use of patents or copyrights, with the state, and (E) all other business receipts earned within the state."

3. "The total wages, salaries and other personal service compensation . . . of employees within the state, except general executive officers."

In the case of the Unincorporated Business Tax, the New York factors are:

"1. The average of the real and tangible personal property within the state, (a) at the beginning of the taxable year and (b) at the end of the taxable year, . . .;

"2. The total wages, salaries or other personal service compensation paid during the taxable year . . .;

"3. The gross sales or charges for services performed by or through an agency located within the state. The sales or charges to be allocated to the state shall include all sales negotiated or consummated by salesmen, or services performed by other representatives, attached to or sent from offices, or other agencies, situated within the state."

It can be seen by a rapid examination that these factors are roughly parallel. However, there are very definite differences which may, in a particular case, become of some importance. As to the first factor in each case, it should be noted that for the Franchise Tax, it is an average value for the entire period covered by the report which is called for, while in the case of the Unincorporated Business Tax it is the average value at the beginning and end of the taxable year. In most cases where the main factor is real estate, little can be expected from an investigation of this factor; but where personal property is involved, it may very well be that at the beginning and end of the fiscal year, the proportion of the tangible personal property of the taxpayer within the state to that outside the state may be either more or less than the annual average. Further it may be possible, in the case of the Unincorporated Business Tax, to control the proportion of the property which is in the state at the beginning and end of the fiscal year, by making no shipments, for example, from an out-of-state warehouse or factory into the state for some period prior to the end of the year, thereby lowering this proportion appreciably. A business which manufactured its goods out of the state throughout the year for sales, let us say, during the spring, summer and fall would be likely to find itself with almost no inventory in the state on January 1st, and would therefore have a very low allocation percentage as far as this factor is concerned.

Factor number 2 for the Unincorporated Business Tax is very similar to factor number 3 for the Franchise Tax, the only difference being that in the case of the Franchise Tax compensation of "general executive officers" is to be omitted. I have a feeling that this was put in, in part at least, to make the situation with respect to corporations and unincorporated entities similar, since we would probably find that the persons who are the general executive officers of a corporation would be the partners of a partnership. However, it might very well be that some of the general executive officers as defined in Article 414 (2) of the new Franchise Tax regulations might be persons who would not be partners of the unincorporated entity, or *vice versa.* The location of such a person, whether in or out of the state, might in a particular case be an important factor in allocating income for tax purposes.

In the case of the last factor, (factor number 3 for the Unincorporated Busi-

ness Tax and factor number 2 for the Franchise Tax) we also find certain very definite and possibly important differences. It should be noted that for the purposes of the Unincorporated Business Tax, what counts is the headquarters of the salesmen or other representatives of the organization. In the case of the Franchise Tax, the location of the property at the time of the receipt of or appropriation to the order is the thing that counts. It would appear, then, that an unincorporated business setting up an office outside the state for the sale of merchandise located within the state could sell such merchandise without the requirement that such a sale be included in the New York portion of the allocation factor. Also, it should be noted that the Franchise Tax Law is specific as the inclusion of certain items which would apparently be excluded for purposes of the formulae under the Unincorporated Business Tax Law.

Another item to consider in determining the effect of the type of business organization is the fact that the Franchise Tax law distinguishes between business income and investment and subsidiary income, while the entire income of an unincorporated business is treated as one item. This factor too should be considered in determining the amount of tax which will be likely to be paid in the alternative conditions.

It should be noted, finally, that in the case of both the Franchise Tax and the Unincorporated Business Tax, equity may require that another method of allocation be followed, but of course that would be the unusual rather than the usual situation. Normally, we may expect that the statutory allocation formula will be used in the determination of net income subject to tax and an examination of this factor is certainly warranted in all cases; in many cases it will undoubtedly give us another item to be considered in the determination of whether a particular business entity should be carried on as an unincorporated business or as a corporation.

The Break-Even Point

The concept of the break-even point is becoming better understood both to management and accountants. Too many people, however, believe that a break-even point may be estimated simply because we lose money at one level and make money at another level of activity, the break-even point lying somewhere between. In order to understand that full significance of this concept, we must know what factors affect the break-even point under varied conditions. The accountant must educate management so that in the break-even analysis by lines of product, it has at its command the tools for pruning, culling, and correcting poor and unprofitable lines as well as the tools for improving those lines which show possibilities in the future.

Management and the Accountant, by Oliver E. Mount, N. A. C. A. Bulletin (Sec. One); January 15, 1947.

Discretionary Adjustment of the Business Allocation Percentage-Property Factor and How It Operates

By BENJAMIN HARROW, C.P.A.

THE New York State Tax Commission has issued a ruling which under certain conditions permits a corporation taxable under Article 9-A of the Tax Law and entitled to an allocation of its business income and capital, to substitute a business expense ratio for a property ratio in the calculation of the taxpayer's business allocation percentage.

This substitution is permissive with the Tax Commission and may be allowed upon proper application of the taxpayer or required by the Commission, of its own motion.

In order to qualify for this adjustment in the business allocation percentage the corporation

(a) must be taxable under 9-A of the Tax Law;

(b) must be entitled to an allocation of its business income and capital; and

(c) must own (within and without New York) no real property and whose ownership of tangible personal property (within and without New York) is comprised solely of furniture, fixtures and other office equipment.

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Under the old law, a corporation conducting activities in and out of the State of New York was entitled to allocate its entire net income in accordance with the proportions of the values of certain specified assets of the corporation within the State to the total values of such assets owned by the corporation wherever situated. The assets specified by law for use in making the allocation were:

(1) real and tangible personal property;

(2) designated bills and accounts receivable arising from business done; and

(3) stocks of other corporations owned by the taxpayer corporation.

New Article 9-A provides for different allocation methods with respect to business income and capital, investment income and capital, and subsidiary capital.

Business income and capital generally are allocated by a "business allocation percentage". However, a corporation is not entitled to an allocation of business income and capital unless it maintains a regular place of business outside of the State. If it does not, its allocation percentage is one hundred per cent. In this connection, it is important to note that a statu-

tory office is not a regular place of business, but a rented office is.

If the taxpayer is entitled to an allocation of business income and capital, its business allocation generally is computed in accordance with Section 210, as follows:

1. Ascertain the percentage which the average value of real and tangible personal property owned by taxpayer within the state bears to the average value of all the taxpayer's real and tangible personal property wherever situated.

2. Ascertain the percentage which gross sales or revenue of the taxpayer attributable to the state bear to the total gross sales or revenue wherever attributable.

3. Ascertain the percentage which the total payroll of employees, except general executive officers, within the state bears to the total payroll of all employees, except general executive officers, within and without the state.

4. Add the percentages obtained in 1, 2, and 3 above together and divide the result by three.

Example 1:

A corporation owns real and tangible personal property having an average value of $50,000 during 1945. Of this, $10,000 is located in New York State. Its only source of revenue is from sales of tangible personal property. During 1945, sales attributable to New York State amounted to $240,000 out of total sales of $800,000. The total payroll of all employees, except general executive officers, was $10,000. Of this, $5,000 was attributable to employees without the state. Its business allocation percentage would be 33⅓ per cent, computed as follows:

1.	Average Value of Real and Tangible Personal Property Within State	$10,000	
	Total Average Value of Real and Tangible Personal Property	$50,000	= .20
2.	Gross Sales Attributable to State.........	$240,000	
	Total Gross Sales......................	$800,000	= .30
3.	Payroll of Employees Within State........	$ 5,000	
	Total Payroll of Employees.............	$ 10,000	= .50
4.	Total		1.00

5. Average: 1.00 ÷ 3 = .33⅓.

However if one of the factors is completely missing, the other two percentages are added and the sum is divided by two. If two are missing, the third becomes the business allocation percentage. If, in the above illustration, the property factor were missing, the business allocation percentage would be 40 per cent ([.30 + .50] ÷ 2). A factor is considered as missing only if both its numerator and denominator are zero. If only the numerator is zero the percentage of the factor would be zero.

Example 2:

Same facts as in example 1, except that all real and tangible property is located without the state.

Discretionary Adjustment of Business Allocation Percentage-Property Factor

1.	Average Value of Real and Tangible Personal Property Within State .... / Total Average Value of Real and Tangible Personal Property	=	0 / $50,000	= .00
2.	Gross Sales Attributable to State......... / Total Gross Sales........	=	$240,000 / $800,000	= .30
3.	Payroll of Employees Within State........ / Total Payroll of Employees........	=	$ 5,000 / $ 10,000	= .50
4.	Total			.80

5. Average: $.80 \div 3 = .26\frac{2}{3}$.

It is obvious that the greater the proportion of property, receipts and wages allocable without New York to those allocable within New York, the more favorable will be the result of the allocation formula for the taxpayer. The converse is also true.

While receipts and wages are ordinarily a fairly reliable measure of the amount of business done within and without the state, this may not always be the case with property owned. Thus, a corporation entitled to allocate its income and owning the building in which it maintains its out-of-state office would be in a much more advantageous position than a similar corporation renting its out-of-state place of business. The property allocation factor of the former, assuming no other property outside of New York, would be

$$\frac{\text{Average Value of New York Property}}{\text{Average Value of New York Property Plus Outside of New York Property}}$$

or something less than 100%. However the second corporation would have a property allocation factor of 100% since it owns no property outside of the state.

The distortion brought about by the property allocation factor can be greater in the case of corporations which do not own real property or inventories. Here the business allocation percentage is influenced to the extent of one-third by the value of furniture and fixtures within the state and outside the state.

Example 3:

A corporation has 60% of its receipts from sales in New York; pays 80% of its wages and salaries in New York; and has furniture and fixtures worth $1,000 in New York; while the furniture and fixtures in its place of business outside of New York has been fully depreciated. It owns no other real or tangible personal property. Its total business allocation percentage would be

$$\frac{.60 + .80 + 1.00}{3} = 80\%$$

If the furniture and fixtures in New York had been fully depreciated, while the furniture and fixtures outside of New York had a value of $1,000, its business allocation percentage would be

$$\frac{.60 + .80 + 0}{3} = 46.67\%$$

If no real or tangible personal property at all is owned by the corporation

the business allocation percentage would be

$$\frac{.60 + .80}{2} = 70\%$$

In order to avoid such inequities, the State Tax Commission based on Section 210 (8) of the law issued, on July 30, 1946, the ruling already referred to which reads in part as follows:

"1. In the case of any corporation (a) taxable under Article 9A of the Tax Law, (b) entitled to an allocation of its business and capital, and (c) which (within and without New York) owns no real property and whose ownership of tangible personal property (within and without New York) is comprised solely of furniture, fixtures and other office equipment, the Tax Commission will, upon application of the taxpayer, eliminate the property factor in the calculation of the taxpayer's business allocation percentage. In such a case, the Commission may substitute, as a third factor, the percentage which the taxpayer's business expenses (other than salaries and wages) incurred or expended within and without New York.

"2. * * *

"3. In the case of any corporation circumstanced as above, the Commission may, of its own motion, make a discretionary adjustment by the elimination of the property factor, and * * * *, may substitute as a third factor the percentage of expenses as set forth above.

"4. Business expenses include only expenses used in the calculation of the taxpayer's entire net income incurred or expended in service, maintenance and operation of a nature as may be allocated within and without the state * * * *."

Since the above ruling applies to all franchise tax returns filed on or after May 15, 1945, it is incumbent on all taxpayers coming within its purview to re-examine the calculation of its business allocation percentage for the purpose of determining to what extent it may be affected.

A New Income Year for Taxpayers

An essential condition for the proper control of the public finances is the integration of the tax year with the budget year. That is, tax levies, tax rates, and tax payments should be adjusted to the fiscal period in which the revenues thereby provided are to be spent. . . . There is one conspicuous instance, at the federal level, in which such a correction should be made.

The case in point is the use of the calendar year as the period for which to report income and determine the total tax due on the income received during a twelve-month period. Individuals and corporations that regularly use a fiscal year for their own purposes are authorized by the tax law to report income and settle tax liability on the basis of this fiscal year. All other income taxpayers are required to make such reports and settlements on the basis of the calendar year.

On the other hand, the federal finances are managed on the basis of a fiscal year which opens on July 1 and closes on the next June 30. The budget is regularly planned with reference to this fiscal year. The estimates of revenue must be converted, from the results obtained out of the experience of income reported and taxes paid on a calendar year basis, into approximations valid for the fiscal year which cuts across the middle of the income and tax payment year that is used by the large majority of all taxpayers.

The significance of the lack of synchronization between the tax year and the budget year has often been made apparent in the reports of the Congressional taxing committees.

* * *

. . . the occasion is most auspicious for a change in the income year and tax year for all who do not now use, or who may hereafter elect to use, a fiscal year of their own choosing. The new income and tax year should be identical with the federal fiscal year, and not, as heretofore, with the calendar year.

* * *

A New Income Year for Taxpayers, by HARLEY L. LUTZ,
The Tax Review; January, 1947.

Some Comments on New York State Taxes

By Sidney I. Roberts, C.P.A.

Importance of State Taxes

THE subject of State taxation does not appear to be getting the attention it warrants. In the hectic years just past, more important phases of the accounting function demanded our attention. Now we should be able to spare more time for State taxes.

During the war years some may have derived comfort from the knowledge that any error of overpayment was borne principally by the Federal government. Now a corporation suffers 62% of the amount of such errors as compared with as little as 14.5% previously. The subject has therefore become much more important from a dollars and cents viewpoint.

Again, consider the paucity of New York rulings published as compared to the numerous guides issued currently by the Federal tax administrators. The regulations under the new Franchise Tax law were a promising and creditable step forward. But there are many gaps which can be closed only by experience with the law. Published rulings have been very few to date. Discussion and exchange of information can prove invaluable to practitioners in filling the voids left by the administrators. This article discusses some miscellaneous problems, which may be of general interest to practitioners.

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Leasehold Improvements as Tangible Property

Most of the formulae for allocating multi-state income make use of the tangible property factor. For example, it enters into the computation of the allocation percentage in the New York Franchise Tax, the New York Unincorporated Business Tax, and the New York Personal Income Tax, as well as the New York City Gross Receipts Tax.

Are leasehold improvements included in the computation of the tangible property factor of the tenant? Suppose a corporation leases its sales and executive offices located in New York, but owns the realty of its manufacturing plant located in Pennsylvania. Exclusion of leasehold improvements may materially change the allocation percentage and, consequently, the amount of tax.

A "Leasehold Improvements" account might include anything from a repaint job to a building. The first step is to analyze the account to determine the nature of the expenditure. It appears clear that where the leasehold improvements constitute "fixtures" which legally remain the property of the tenant, they are properly classified as tangible property of the tenant. Such improvements are in the same category as furniture.

But suppose your tenant has leasehold improvements which are permanently affixed to the realty and thereby legally become part of the real estate owned by the landlord. For example, suppose the tenant erects permanent partitions, or an entire building on the leased property. In such a case the improvements are "tangible" enough. But they are owned by the landlord, not the tenant. Do these improvements enter into the computation of the tenant's tangible property factor?

It seems clear that the leasehold it-

self is not tangible property. Generally it does not even appear on the balance sheet. Even if reflected on the balance sheet, as where the tenant paid advance rentals, the property rights of the tenant in the leasehold are generally considered intangible property. And apparently the same result is reached whether the property is vacant or improved.

Suppose, however, that pursuant to the terms of the lease the tenant erects a building retaining no privilege of removal on termination of the lease. The tenant's rights in respect of the building appear to be substantially the same whether the tenant or the landlord put up the building. In either case he has the right to use the building for the period of the lease. Since a building erected by the landlord does not enter into the computation of the tangible property factor of the tenant, a strong argument may be made for similar treatment of a building erected by the tenant.

Nor does this result appear inequitable. Why should a tenant who makes improvements on leased property which become part of the realty have a tangible property factor different from one who pays more rent because the landlord makes the improvements? True, there is a difference in treatment between the taxpayer who leases property and one who owns property. But this differentiation is inherent in the use of tangible property as a factor in an allocation formula. It is noteworthy that on this common problem there appears to be meager authority.

Treasury Stock and The New York Franchise Tax

The statute and regulations under the New York State Franchise Tax are silent as to the treatment of treasury stock, *i. e.*, stock of the taxpayer acquired by it and not cancelled. Nevertheless important differences may result from difference in treatment thereof.

If treated as a reduction of capital stock, it reduces Business Capital. If treated as an asset, presumably it becomes Investment Capital and, as such, enters into the computation of the Investment Allocation Percentage.

Neither the law nor the regulations make provision for the treatment of treasury stock. The definition of Investment Capital in the law (Section 208.5) does not preclude treasury stock. The Regulations expand on the statutory definition to include "the taxpayer's *investments* in stocks, bonds and other securities issued by any corporation (other than a subsidiary) . . ." Treasury stock, it may be argued, falls within the literal wording of the Regulations. However, it cannot be said that such result was contemplated by the framers of the Regulations.

Form 3CT (46) at Schedule C would have you copy the balance sheet from the Federal income tax return. But this merely shifts the problem one step backward, for Schedule L of the Federal return makes no specific provision for treasury stock. However, the Federal income tax law may provide persuasive authority for treatment of treasury stock under the New York tax law. For excess profits tax purposes, treasury stock may be treated as an inadmissible if not acquired for retirement. (U. S. Treas. Reg. 112, Section 35.718-5). Treatment as an inadmissible for the Federal excess profits tax closely parallels treatment as Investment Capital for the New York State Franchise Tax. Moreover, for Federal income tax, gain on treasury stock may be taxable if the corporation deals in its own stock as it would deal in the stock of another. (U. S. Treas. Reg. 111, Section 29.22 (a)-15). In the year in which the taxpayer reported a gain on treasury stock to the Federal government (which would enter into the computation of the New York Franchise Tax), it would not seem consistant to deny treatment of such treasury stock as Investment Capital or the gain thereon, as Investment Income.

For purposes of simplicity, the tax administrators may provide a rule of uniformly treating treasury stock as

a reduction of capital rather than as an asset. However, it will be interesting to observe their position in the year in which a gain on sale thereof is included in income.

Minimum 15% Investment Allocation Percentage

A common error in the preparation of the New York Franchise Tax return occurs in the application of the 15% floor on the investment Allocation Percentage. References to the law and regulations or a careful reading of Form 3CT (46) will help to avoid the mistake.

Unless the taxpayer establishes that less than 15% of its investment capital is employed, and less than 15% of its investment activities is conducted within the State, the Investment Allocation Percentage may not be less than 15%. However, the law and regulations are explicit in limiting the application of the minimum to the allocation of Investment *Capital*. In allocating Investment *Income* there is no minimum and the Investment Allocation Percentage otherwise determined may be applied, although less than 15%. (See Art. 9-a, Section 210.5; Regulations, Art. 422).

Form 3CT (46) makes proper provision for the foregoing distinction. At Schedule M, Item 2, the *actual* Investment Allocation Percentage should be inserted, even though less than 15%. The common error is to place the 15% minimum here where it is evident that the actual percentage is less than 15%. The actual percentage, inserted at Schedule M, Item 2, should be carried forward to Schedule P, Item 2. Thus the Investment *Income* is allocated by the Investment Allocation Percentage without regard to any minimum. However, in carrying forward the Investment Allocation Percentage to Schedule P, Item 6, for allocation of Investment *Capital*, Form 3CT (46) at Item 6, refers to instruction 24 which makes provision for the 15% minimum. Hence, the Investment Allocation Percentage at Item 2 may be less than 15%, but at Item 6 the minimum applies. The significance of the reference to Instruction 24 (the 15% floor) at Item 6 of Schedule P and the ommission of such reference at Item 2 should not be overlooked.

Foreign Tax Credit on New York Franchise Tax

An item which may be overlooked because Form 3CT (46) makes no provision therefor, is the credit allowed for foreign taxes. Under the Internal Revenue Code, a taxpayer may elect to treat certain foreign income taxes as a deduction or, under Section 31, as a credit. If the foreign taxes were taken as a deduction, the taxpayer will automatically get the benefit thereof on the New York Franchise Tax Form 3CT (46) because it will be included along with other taxes at line 22. On the other hand, if the foreign taxes were taken as a credit on the Federal return, the deduction for New York Franchise tax purposes may be overlooked if the form is carelessly followed. Yet the Regulations, Article 311 (B) (3), makes specific provision for the deduction.

Moreover, the deduction allowed on the New York Franchise Tax return may exceed the amount of the credit allowed on the Federal return. This will occur when only a portion of the foreign tax was allowed as a credit on the Federal return because of the Federal statutory limitations. In such case, the entire amount of the foreign tax is allowed as a deduction for the New York tax. The aforementioned regulations provide for deduction of

> "Income, war-profits and excess profits taxed imposed by foreign countries or possession of the United States, *any part of which* was allowed as a credit against the Federal income tax under section 31 of the Internal Revenue Code. (Italics supplied)."

Some Aspects of the Real Estate Franchise Tax

By STANLEY B. TUNICK, C.P.A.

MY purpose tonight, in talking about the real estate franchise tax, is to review the things that most of you undoubtedly know and yet may overlook, when returns are being prepared.

Qualifications for Filing

First of all, one must keep in mind the companies which may file as real estate corporations. But even before that, we must understand the meaning of "corporation." "Corporation" has been defined to include any business conducted by a trustee where a participating interest is evidenced by a certificate or written instrument. Such certificates need not be transferable. The law is clear as to what constitutes a real estate corporation. It must be wholly engaged in New York State in one or more of the following activities: (1) the purchase, sale or holding of real estate for itself; (2) the subleasing of realty under a lease for 20 years or more, by the terms of which it is obligated to pay the taxes on the realty; (3) the holding of bonds, notes, or other obligations given by a purchaser of realty or leaseholds sold by the corporation and secured by that which was sold. A real estate corporation may own the entire stock of another real estate corporation, and it may own securities, not necessarily real estate securities, not in excess of 10% of the gross assets held by it during any year. During the war's duration, and that is a term which is not easily defined, it may own any amount of U. S. government bonds bought by it after 1940. Incidentally, it has been held that submetering electricity to tenants has not constituted disqualification for filing as a real estate corporation.

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This address was delivered on January 23, 1947, at the meeting of the Society devoted to a consideration of New York State franchise tax problems.

But when a real estate corporation goes beyond any of the activities mentioned, it loses its status as a real estate corporation and becomes taxable as a business corporation under article 9A. Thus, a company which might otherwise qualify as a real estate corporation, but which is itself owned or controlled by a business corporation that uses or occupies all or part of the former's property, is taxed as a business corporation. Ownership of the stock of real estate corporations does not itself qualify the holder to file as a real estate corporation unless the latter engages in activities as defined in the statute.

A lease for less than 20 years with an option to renew, which if exercised would extend the term beyond 20 years, does not permit a corporation to qualify. However, a company may construct buildings on its own land without losing its status as a real estate corporation.

Accrual of Tax

The real estate franchise tax accrues on January 1st of each year, and every corporation then in existence is subject to the tax. The fact that a corporation is inactive doesn't excuse it from the liability to pay the tax, because the tax is paid for the franchise and not for the exercise thereof. On the

other hand, a corporation which is newly organized during any year is not subject to the tax until the next calendar year, since it was not in business on January 1st of the year of its organization. Formal dissolution, or in the case of a foreign corporation, withdrawal from the state before January 1st, are the only ways in which a corporation may avoid further tax liability. Where a domestic corporation applies to the tax commission before January 1st for consent to dissolve, and its certificate of dissolution is filed in the office of the Secretary of State within 20 days after such application (even after January 1st), no liability for further tax is incurred.

Tax Rates and Basis

You all know that the tax rates are 2% of the allocated dividends and taxable interest, plus ¼ of a mill on each dollar of gross assets owned on December 31st of the company's preceding year. The latter part of the tax may not be less than $10. The tax on gross assets can be reduced by selling before December 31st and buying after January 1st. The dividends and taxable interest which are subject to tax are only those actually paid and do not include any declared or accrued. For purposes of the tax, a stock dividend which has been distributed is deemed subject to the tax, since the tax attempts to reach all distributions to stockholders which tend to reduce surplus.

The tax on assets, according to the practice of the Tax Commission, is based on the full value thereof, which is usually interpreted to mean the highest of the book, mortgage, and assessed values. I think that I am safe in saying that most corporations report and pay on the basis of book values, and rely on their ability to overcome the State's contention and possible demand for higher taxes by showing that the assessed values, where they exceed book values, are too high. One way of doing that is by showing that requests for certiorari review by courts have been filed for the year in question. It is still better to show that in years past similar requests were filed and that the courts have decided in the taxpayer's favor and have actually reduced the assessments for those other years. Where book values are in excess of real values, it might be good to write them down to avoid an assessment by the Tax Commission based on such higher values.

The privilege year is the calendar year. Until the present time, a real estate corporation, in filing its franchise tax return before March 1 each year, was required to report on its activities during the preceding calendar year. This has now been changed. The efforts of our Society spread over many years have finally borne fruit. If you have seen the new franchise tax form, you will have noticed that gross corporate income and net corporate income must now be reported for the reporting company's calendar year or fiscal year ended in 1946, to coincide with the method followed in reporting for federal income tax purposes. Previously, the bookkeeping of the reporting company was ignored, and real estate corporations were required to report only on a calendar-year basis. This made for much confusion, but that is now done away with.

You will also have noticed that the new form makes provision for setting up balance sheets as of the beginning and the end of the fiscal year, in exactly the same way that they are reported to the United States Treasury Department. The Reconciliation of Surplus is likewise prepared for the same period as that reported for federal income tax purposes.

However, real estate corporations will continue to pay before March 1 of each year, a tax on gross assets located in New York State on the preceding December 31, and on allocated dividends and taxable interest paid during the preceding calendar year. To enable the State to ascertain whether the amount of interest on which payment is being made is correct, the form provides for a reconciliation of such inter-

est with the amount previously accrued. Unfortunately, that reconciliation will not in 1947 furnish the necessary information to the State. On the return filed in 1946 before March 1 of that year, the reconciliation ended with the interest accrued at the end of 1945. But that amount is not now picked up in each case. Instead, we start with the interest accrued at the end of the calendar or fiscal year ended in 1945. Unless the company regularly reports on a calendar-year basis, these two amounts will not be the same. Furthermore, the reconciliation of surplus will not tie in dividends correctly since some may have been paid during the calendar year, but after the end of the fiscal year. I can foresee letters written by the State Tax Commission asking for details concerning these different amounts, and for information about interest and dividends paid during the calendar year but after the end of the fiscal year. It is, therefore, my suggestion that we, as accountants, anticipate these requests, and attach to the franchise tax return, as filed, a statement which will furnish the State with the details for a real reconciliation of surplus and accrued interest. Start with the balances as of December 31, 1945, and connect them with those shown on the current return as of the beginning of the company's fiscal year, and then carry through to December 31, 1946, by showing payments made between the end of the company's fiscal year and December 31. By doing this now, you will save much time later on, and the State Tax Commission will be able to determine whether the tax paid is actually based on the dividends and interest paid during 1946.

Interest Subject to Tax

I have referred several times to the 2% tax on allocated dividends and taxable interest. It is important to know just what interest payments are subject to the tax. They are summarized as follows: interest paid on debenture bonds, certificates of indebtedness, and certificates of beneficial interest, whether or not paid to stockholders, and interest paid to stockholders on unsecured obligations, in all cases where the proceeds of such instruments were used, directly or indirectly, to acquire corporate assets.

The reason for taxing this interest is easily understandable. Basically the 2% tax is on distributions of earned surplus, but not on paid-in surplus or on return of capital. Many real estate corporations are undercapitalized, and you will find many of them capitalized at relatively a few dollars although the owners of huge pieces of expensive real estate. The money necessary for such purchases has come from borrowings of one kind or another, or from people interested in the corporation, whose real interest has been disguised and represented perhaps by a certificate of beneficial interest. The State looks through these disguises and takes the position that, had the corporation been properly capitalized, the payments would not have been interest, but dividends on stock. And while we are on the point, attention is invited to the fact that excessive salaries to officers and loans to stockholders are sometimes held to be dividend distributions and are, therefore, taxed at 2%. With respect to loans, the status thereof is checked into, and the 2% tax is levied on them where there does not appear to be any intention of the borrowers to repay. Evidence of this may appear in a loan account, the balance of which grows increasingly large without any indication of repayment, even in part.

Allocation

Allocation to New York State is accomplished by determining the average assets, exclusive of cash, employed within the State and everywhere, during the year covered by the report.

There is no rule for determining when assets are employed in or out of the state. Obviously there is no problem with respect to realty. Intangibles of a domestic corporation would be considered New York assets and those of

a foreign corporation out-of-state assets. Stocks of other corporations may be allocated on the basis of values reported by those corporations on their own returns, and this information can be obtained from the Tax Commission. Waiver of apportionment of assets is not permitted, but apportionment out of the state is allowed only when the reporting corporation has real estate, or maintains an office, out of the state. The ratio of average assets in New York to average total assets is applied to the dividends and taxable interest paid to determine the portion thereof which is taxed at 2%.

Change of Status

When the change occurs because of dissolution, a tax of 2% is levied on dividends and taxable interest not previously taxed, and on surplus available for distribution, to the extent that they are allocated to New York. If the change is one of classification from real estate to business corporation, the tax is 2% of dividends and taxable interest paid since the end of the preceding business year and on the excess of the corporation's net worth over the amount of its paid-in capital to the extent that they are allocated to New York. The commission takes the position, moreover, that a corporation, originally taxed under Article 9A which later became taxable under Article 9, and still later was reclassified under 9A, is taxed at the last change on undistributed surplus, some of which may have been earned while it was first classified under Article 9A.

In the case of change-over of status from real estate to business corporation, the liability for business franchise tax begins on the day of change-over. The date of change-over, however, is not always easily ascertainable. For instance, a real estate corporation is permitted to own stocks up to 10% of its average gross assets during any given year. However, it would not be until the end of the year that one could tell whether the average investment in stocks was more than 10% of average assets, and therefore, whether the company was disqualified from continuing to file as a real estate corporation. Furthermore, a corporation should be careful not to approach the 10% mark too closely, since values of securities fluctuate, and what may at one time have been less than 10% might have become more than that amount.

Miscellaneous Points to Keep in Mind

Insolvent corporations are not required to file returns or pay taxes. But if receivers or trustees conduct the business, they are required to file and pay. Delinquent taxes become a lien on corporate property on January 1st, which lien is, however, subordinate to prior mortgages and to local taxes and assessments, past or future. Unpaid taxes are also a lien or rents received by a corporation's assignee. The lien is good for 10 years against purchasers or holders of mortgages in good faith except for such lien. A lien for additional tax assessment is not applicable to property conveyed prior to audit. The tax commission will release part of a company's realty from a lien upon payment of a $5 fee and adequate consideration for the lien. One point to remember is that no purchase of realty should be made from a corporation without first investigating whether there is any outstanding lien on such realty for unpaid taxes.

Preparation and Filing of Return

Before I close, I want to say something about the return. First of all, as you know, the filing date is between January 1st and March 1st of each year, and on filing, the return should be verified by an officer. For good cause an extension of time for filing may be obtained upon application to the Tax Commission. However, a tentative return must be filed in any case and the tax paid before March 1st.

While the returns are not open to the public, a corporation may obtain copies of its own returns from the Tax Commission. Production of returns

may be required in court in cases where they are involved. Furthermore, the Tax Commission is permitted, under reciprocal agreement, to exchange information contained in returns with State and Federal tax officials. In addition, statistics based on returns may be published by the State if details of particular returns are not revealed. Because of the reciprocity privilege corporations should always see to it that information furnished on federal income tax returns is consistent with that reported on franchise tax returns.

As for the return itself, make sure that each question is answered even if only with a "no" or "none". Another word of caution—make sure that each question is understood and is correctly answered. In my opinion, the real estate franchise tax return is one of the finest self-auditing returns taxpayers are called upon to file. The Tax Commission has prepared it so that certain pertinent information will be forthcoming. The same information is requested in several different ways, and misinformation furnished in answer to one question may show up in answer to another question on the same return. The Tax Commission is interested primarily in determining whether the filing corporation qualifies as a real estate corporation, and secondly, the amount of the corporation's indebtedness for taxes. The questions and schedules are built around these ideas. They furnish data concerning the reasonableness of some of the amounts reported. Actually they go even further. They enable the Commission to trace real estate transfers and to see if income taxes on such transfers have been properly reported.

The license fee block on the return must be filled in only by foreign corporations. Its purpose is to show whether any additional license fee is due because of an increase in capitalization or in assets employed in New York. Each year the fee is recomputed, but credit is allowed for payments made in previous years. Allocation is based on the fraction computed for dividends and taxable interest.

Assessments by the Tax Commission

The Tax Commission may make an assessment for additional taxes within 5 years after a return has been filed, except in the case of fraud, in which case the assessment may be made at any time.

Application for Revision and Refund

Application for revision or refund must be made within 2 years after filing return or after notice of assessment. In the latter case, it is not likely that objections could be raised relative to matters not involved in the assessment. The Tax Commission's determination may be reviewed through certiorari by the Supreme Court, and the Tax Commission must be given 8 days notice of the application to the court, which notice must be given within 90 days after service of the notice of the determination. The tax, interest, and other charges must be deposited with the Commission, together with an undertaking for costs, or the undertaking may cover the tax as well as costs.

Penalties

For delinquent filing, the civil penalty against the corporation may be \$5,000. The fraud civil penalty against an officer or an agent signing for the corporation may be \$1,000. For delinquent payments, the penalty is 5% of the tax, plus 1% thereof for each month of delinquency. Criminal penalties consisting of a \$5,000 fine and imprisonment are provided against the corporation, its officers, agent or employees for wilful failure to file the report. The Commission may compromise civilian penalties, but may compromise taxes only in the case of insolvency.

Summary

It is difficult, in the short time allowed, to discuss the real estate franchise tax in detail. At best, only the highlights can be covered. Nevertheless, I have attempted quickly to review the law and the tax return, and I sincerely trust that in attempting to talk of many things I haven't rushed too much.

A Note on the Saltser and Weinsier Case

By N. Harry Sack, C.P.A.

One of the most important decisions in 1946 affecting the New York City Sales Tax is the case of *Saltser & Weinsier* vs. *McGoldrick* decided by the New York Court of Appeals on July 23, 1946. This case involved the power of the Comptroller to make in December, 1943, a re-determination of sales tax deficiencies which he had determined more than five years prior thereto for the periods from December 10, 1934, to December 31, 1937.

Under the local laws effective when the original deficiencies were made, the Comptroller was empowered "to assess, revise, readjust and impose the taxes authorized to be imposed". These local laws further provided that notice of a determination was final and irrevocable unless the taxpayer applied for a hearing within thirty days after the giving of such notice. In Section N 41-7.0 of the Administrative Code which sets forth the rules for determining tax deficiencies under the Sales Tax Law, the Comptroller was given the additional power to *re-determine* a deficiency on his own motion. In an amendment to this section by Local Law 26 of 1942, effective July 1, 1942 (not Local Law 18 of 1943 referred to in the opinion) Section N 41-7.0 was made applicable to returns required to be filed under the Sales Tax Laws in effect prior to July 1, 1942, as well as those required to be filed thereafter.

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In construing Section N 41-7.0, the Court held that the power to make a *re-determination* of a deficiency is not included in the power "to assess, revise, readjust and impose" the Sales Taxes which was contained in the prior local law. In addition, the Court held that the 1942 amendment was not intended to have retroactive effect. The amendment, it stated, is to be construed as prospective only and authorizing the Comptroller to re-determine a deficiency assessment only when the first determination is made after the effective date of the amendment, namely, July 1, 1942.

The significance of the decision is the inference in the Court's opinion that a determination of a deficiency, assessed after July 1, 1942, and made final and irrevocable so far as the taxpayer is concerned may be re-determined by the Comptroller upon his own motion. Although the Court did not discuss the question of the Statute of Limitations, apparently a re-determination must be made within three years from the date of filing the return or within the period of extension of the Statute, unless there is fraud, in which case there is no limitation.

Some Accounting Problems of a Central Industrial Reporting Agency Operating Pursuant to Regulation 24D Under the New York State Unemployment Insurance Law

By Samuel S. Ress

Any employer, who pays wages to persons employed in "employment" as defined in the Unemployment Insurance Law, but who claims that by virtue of Section 560, subdivision 3* thereof, he is not liable for contributions on wages paid for work in respect to which he has agreed to contract with any other person or persons pursuant to an agreement under which he operates, is, nevertheless, required to submit a Contractor's Report of Contributions on Form TW 5.1 as well as Form TW 56, the Quarterly Payroll Report, to the Division of Placement and Unemployment Insurance of the New York State Department of Labor. The contractor is required to submit a copy of the agreement under which he operates and to report on Form TW 5.1 the name, address, employer registration number of each manufacturer or jobber by whom he is employed and to allocate the contribution liability payable on the wages paid by the contractor to his employees among the various manufacturers or jobbers for whom he did work during the calendar quarter.

Samuel S. Ress has been an Associate Member of our Society since 1936. He is a member of the New York Bar and holds the Juris Doctor degree from the New York University School of Law, and the B.B.A. degree from The College of the City of New York. He is a tax consultant and has been a specialist in the payroll tax field since the inception of Social Security and Unemployment Insurance Laws in 1946.

The opinions expressed in this paper are the personal views of the writer and do not necessarily represent those of the central agency with which he is connected.

The reporting requirements on behalf of contractors may be satisfied if made through a central agency of the industry in which the contractor operates. The women's dress, coat and suit industry as well as the men's and boys' clothing industries in the Metropolitan area have established such central representative agencies, duly authorized by the parties to the industrial agreements in effect in those industries to administer these pertinent provisions of the Unemployment Insurance regulations as well as those involving the preparation, filing and reporting to the Internal Revenue Bureau for Federal Insurance Contributions Act (Social Security), Federal Unemployment Tax Act and Federal Payroll Withholding Tax purposes.

The accounting problems of such an agency are many, since they arise from the necessity of accumulating the nec-

* Subdivision 3, Section 560 of New York State Unemployment Insurance Law provides: "*Independent enterprises.* In determining whether an employer is liable for contributions and for what contributions he is liable under this article, such employer shall, whenever he contracts with any person for any work which is part of such employer's usual trade, occupation, profession, or enterprise, be deemed to employ all employees employed by such person for such work, and he alone shall be liable for the contributions hereunder with respect to wages paid to such employees for such work, unless such person performs work or is in fact actually available to perform work for anyone who may wish to contract with him and

essary payroll tax information that must be reported quarterly and annually to both the State and Federal Governments on behalf of over a thousand different firms operating in the industry, which firms employ thousands of workers, many of whom are constantly changing their jobs. Similarly, the employers are constantly reorganizing or changing their form of business organization.

The central agency is required to receive copies of each contractor's weekly payroll record showing the contractor's full and correct name, his State Employer Registration Number, his Federal Identification Number, his correct address and the period covering each payroll. He must report each employee's correct Social Security Number, the employee's full name, gross amount earned by each worker, the amount deducted for Federal Payroll Withholding Taxes and the amount deducted for Federal Social Security employee contributions.

To facilitate the filing of this report, special standardized forms are prepared by the central agency once a month, which are distributed to the contractors. The Social Security numbers and names of the workers in each shop are imprinted on the payroll report sheet. Stencils with which the payroll reports have been imprinted have been cut from the original Social Security cards issued by the Social Security Board to individual employees. In this way, errors in reporting of Social Security numbers and names are avoided since the same stencil that is used on the payroll report form is also used on the SS1a, Federal Insurance Contributions Act report, as well as on the

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is also found to be engaged in an independently established trade, business, profession, or enterprise."

Regulation 24, New York State Unemployment Insurance Law provides: *"Obligation of contractors.* a. Any employer who pays wages to persons employed in 'employment' as defined in the unemployment insurance law but who claims that, by virtue of section 560, subdivision 3, thereof, he is not liable for contributions on wages paid for work with respect to which he has agreed to contract with any other person or persons pursuant to an agreement under which he operates shall submit a copy of such agreement and shall certify to the division of placement and unemployment insurance, on forms furnished for this purpose by the division, the name and address of each such person with whom he agreed to contract for such work and other information requested on such forms. Such copy and such certification shall be filed between the first and 10th of the month following the calendar quarter during which the person claiming not to be liable for contributions agreed for the first time to contract for such work under such agreement.

b. Between the first and 10th of the month following each calendar quarter, after a certification was filed in accordance with section a of this regulation and provided it has been determined by the industrial commissioner that, pursuant to section 560, subdivision 3, of such law a person is not liable for contributions on wages paid to employees for work performed pursuant to agreements submitted by him, each such person who has complied with the provisions of section a of this regulation shall inform the division of any changes which occurred during such calendar quarter with respect to the persons with whom he agreed to contract for such work, giving their names and addresses.

c. Special contribution reports on forms furnished for this purpose by the division and quarterly payroll reports as otherwise required by regulation 23 (quarterly payroll reports) from employers liable for contributions shall be submitted by each person who has been held not to be liable for contributions on wages paid to employees pursuant to section 560, subdivision 3, of such law. Such special contribution reports and quarterly payroll reports shall be filed in compliance with instructions printed thereon on the dates prescribed for the filing of reports by regulation 22 (reports and payments of contributions).

d. The requirements of sections a and b of this regulation shall be deemed satisfied if a central or representative agency of the industry in which the person required to submit a copy of the agreement is engaged, duly authorized by the parties to such agreement to do so, shall file with the division within the specified period such copy and certified lists, indicating with respect to each person who claims or who has been held not to be liable for contributions on wages paid for work performed pursuant to such agreement the names and addresses of the person or persons with whom contracts pursuant to such agreement have been entered into and certified lists covering any changes in the identity of such persons."

TW 56, Employer Quarterly Payroll report to the State Unemployment Insurance Division. The amounts earned and the amounts deducted for each week are filled in alongside each worker's name and Social Security number by the contractor. The payroll is then forwarded to the central agency at the close of the month.

Every week the contractor is required to forward a weekly remittance statement indicating the total gross payroll for the week, the date of the week on which it was paid, the amount deducted for employees' Social Security deductions, and the amount deducted for Federal Withholding Tax deductions. When the payroll report is received at the end of the month by the central agency, the totals of the gross amount earned and the amounts deducted for employee payroll taxes are footed and cross-footed in order to check the arithmetical accuracy of the monthly payroll report. The amounts sent in each week for Social Security and Federal Withholding Taxes by the contractor are compared with the totals indicated on the monthly report sheet. If differences are found, a letter is written to the individual contractor indicating the difference and requesting him to explain the error. If there is an under-payment of deductions, he is requested to forward his check covering the under-payment. If he finds that he has erroneously reported an individual employee's earnings or deductions, he forwards a reply to that effect.

Where changes have occurred and new employees appear on the payroll, the names and numbers that are written in are scrutinized and if it appears that incorrect full name or Social Security number is reported, the contractor is immediately requested to send the Social Security card for that individual so that a correct record of State and Federal Unemployment and Social Security report may be made for that individual worker.

The individual employee payroll record card for each worker in each shop is prepared. The cards are filed according to shop groups. From the contractor's monthly payroll report there is posted once a month to the individual employee's card, the gross earnings for the month and the amount of withholding tax deductions. At the end of the quarter, the gross earnings and the withholding tax deductions for the three months are totaled. The total is then entered on the TW 56 Employer Quarterly Payroll Report and on Form SS1a, the Employer's Social Security Tax report. After the individual employee's earnings have been posted, the gross earnings on the individual employee cards are totaled and compared with the independent total taken from the Social Security quarterly payroll report lists, then the top part of Form SS1a is filled in indicating the total number of employees listed in Schedule A, the total taxable wages paid and the employer and employees' tax. Where previous under-payments or over-payments have been paid, appropriate credits or adjustments are taken on lines 4 and 7 of Form SS1a.

In connection with the preparation of Form SS1a, since only the first $3,000 paid to each worker is taxable, while the entire amount of the wages paid is subject to withholding tax, it becomes necessary to know and indicate on the individual employee earning record, the point when the individual employee reached his $3,000 quota, so that any earnings in excess of $3,000 may be excluded from Social Security tax report.

The Withholding Tax to be reported is determined by totaling the withholding tax deductions for the quarter from the individual employee cards and comparing this amount with the total of the weekly withholding tax remittances made by the contractor. Withholding Tax Certificates of deposit are obtained from a duly designated depository and the same are forwarded with the quarterly report to the Collector of Internal Revenue in the proper district.

At the end of the year, Forms W-2

and W-3 are prepared by adding the totals of the gross earnings reported and the total amounts of withholding tax deducted from each individual employee. Forms W-2 are reconciled with Form W-3 and, after reconciliation, the triplicate copy is filed with the Internal Revenue Department. The original and duplicate copies are forwarded to the individual contractor, who distributes them to the individual employees so that they in turn may prepare and file their individual income tax returns.

The New York State Unemployment Insurance contractor's report of contributions on Form TW 5.1 poses several special tasks. In addition to determining the number of employees and the amount of wages subject to contribution, on which contributions at the rate of 2.7% must be computed, there is the additional problem of allocating the unemployment insurance contributions due to the New York State Unemployment Insurance Division on the contractors' payrolls among the various registered manufacturers or jobbers. A contractor may be employed by one, two, three, four or more manufacturers during a quarter. The allocation is made on the basis of production reports that are submitted by the contractor each week to the central agency. For example: if contractor A has a payroll of $40,000 for the 1st Quarter of 1946, and reported a total production of $50,000 during that quarter, of which $25,000 was for manufacturer X, $10,000 for manufacturer Y, and $15,000 for manufacturer Z, the contribution liability of $1,080 (2.7% of $40,000) would be allocated by charging manufacturer X $540, manufacturer Y $216, and manufacturer Z $324, on the contribution report. The remittance that would have to be made to the New York State Unemployment Insurance Division would then be in the name of the manufacturer. In the event that the manufacturer has been allotted a contribution rate credit under the New York State Unemployment Insurance Law, he may apply his Unemployment Insurance Tax Credit against his contractor liability, just as he can against his inside-payroll tax liability. The New York State Unemployment Insurance Division in determining the amount of the manufacturer's unemployment tax credit takes into consideration contributions paid on his contractors' payrolls, as well as those paid on his own direct payrolls.

At the end of the year, the annual return under the Federal Unemployment Tax Act must be filed. Under the Federal Unemployment Tax Act, the contractor is deemed the taxpayer rather than the manufacturer who is deemed the taxpayer under the New York State Unemployment Insurance Law. Therefore, it becomes necessary to add any contributions paid by the manufacturer on behalf of each of his contractors so that a proper credit may be taken for contributions paid into State funds on contractors' payrolls. In addition, an accounting must be kept of any State contributions that have been paid by manufacturers' Unemployment Tax Credits, which are also applicable. In order to make such an accounting, it is necessary to have two sets of ledgers. One set of records is kept in the names of manufacturers indicating the various contractors for whom they are making tax payments, and another set of records by contractors indicating the names of manufacturers who are responsible for the employer payroll taxes that must be paid to the State and Federal Governments. In addition, subsidiary New York State Unemployment tax records must be kept.

The basis of the tax allocation among the manufacturers is the contractor's weekly statement of garments delivered to each of his manufacturers. Individual statements for each manufacturer are reported every week. On the basis of such statements, the manufacturers are charged for the amounts that are required for employer payroll tax purposes that have to be paid periodically to the State and Federal Gov-

ernments. The charges, a copy of the contractor's original statement, is forwarded to the manufacturer along with a bill. The manufacturer checks the statement; if it is correct, he pays the bill. The payments are accumulated in the manufacturer's account and are distributed among the various contractors on the basis of their original reports, for which bills had been submitted to the manufacturers. The paid bills are then sorted according to contractors and are posted to the individual contractors accounts.

In the course of reporting, billing, posting and collecting, as well as paying to the State and Federal Governments the amounts due, differences which arise in the ordinary course of operations have to be adjusted with resulting additional complications requiring special handling.

Changes in the form of business organization require the setting up of a complete new set of records for each account involved, along with the necessary additional registration requirements that the State and Federal Governments call for.

To summarize, the central agency's functions consist of receiving payroll and production reports from the contractor, determining both the contractor's and the manufacturer's payroll tax liability on those reports, preparing and filing all the payroll tax reports with the State and Federal Governments, billing, charging and collecting the employer contributions payable by the manufacturers for their pro-rata share of their contractors payroll tax liability, and remitting the funds with the appropriate reports after making provision for credits, adjustments, etc., to the State and Federal Governments in the names of the taxpayers as set forth by law.

Standards of Reporting

It is well recognized that financial statements which the independent public accountant certifies must fairly present what they purport to show. Notwithstanding general agreement on this point, however, the department occasionally receives from various sources examples of failure to observe accepted standards of reporting. One such example recently received by the department is worthy of note.

According to our information, the opinion paragraph of the report issued by an accountant covering the published report of a rather sizable company included the following qualification:

"Subject to the explanatory comments contained in our full report . . ."

We have been advised that the explanatory comments involved failure to observe inventory taking, failure to confirm trade accounts receivable, appreciation written on the books within the last few years, and failure to charge depreciation on appreciation.

The outstanding basis for criticism is the willingness to condense out the qualifying comments on scope and principles in the report to stockholders. An accountant who expresses an opinion subject only to explanatory comments not available to the person who reads the certificate or the statement to which it relates is subject to severe criticism. It leaves the reader completely uninformed as to whether those comments are highly significant or relatively immaterial. If the former, they should be stated—if the latter, they should not be made the basis of a qualification.

Accounting Research, by Carman G. Blough;
The Certified Public Accountant, January, 1947.

Petty Cash

By Harry Mintzer, C.P.A.

Introduction:

While a discussion of "Petty Cash" may appear to be a "petty" topic, the accounting for petty cash is a feature in the system of practically every client and the audit of petty cash is a part of the program of almost every audit. The very name "petty" has a tendency to obscure the importance of control of petty cash funds. A few words on the subject are therefore not out of order. The accounting for petty cash, in many cases, is extremely loose and haphazard, so that should the custodian of a petty cash fund get it into his mind that he needs a little extra spending money, it would be quite easy to yield to temptation with impunity. Where the custodian of the fund also handles other funds and general records, manipulations in petty cash, if successful, may be the forerunner of more ambitious frauds.

The importance of the audit of petty cash in any particular engagement depends not on the balance or size of the fund, but rather on the volume of money which passes through the fund during the period under review.

Accounting for Petty Cash:

The method of accounting for petty cash in any particular situation depends on the circumstances present—the volume of transactions, the attitude of the owners of the business, the number of people available to keep the records and control the fund, the types of transactions which take place, and whatever other factors are present. However, regardless of the situation it is the duty of the auditor at the minimum, to recognize the possibilities in the client's record keeping and to call to the client's attention any deficiencies which may exist in his system of accounting and the means of correcting them.

Let us see what features, in general, a good petty cash system should have. From an accounting viewpoint the system should show, in as simple a manner as possible, the amount of money in the fund at any time, the money coming into the fund, and where the money goes. In addition it should provide a means of accumulating and analyzing the expenditures from the fund in such a way that it can readily be determined which are the proper accounts to be charged.

From the point of view of control the system should fix responsibility for the money in the fund; it should determine that the money passing through the fund is properly accounted for, and that all expenditures are properly authorized.

There are, in general, two methods of handling petty cash payments. One it to pay current bills out of current receipts. The other method is to set aside a revolving or imprest fund out of which payments are made and which is replenished from time to time as the need arises. The imprest fund method is preferred to the method of payments from current receipts because it makes it easier to fix responsibility for the fund in a person other than the one who handles cash receipts. However, under either method it is possible to control and account for the money, and the fact that there is no imprest fund is not, of itself, an indication that the records are improperly kept. The imprest fund method is preferred where receipts are

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mainly by check and very little in cash, or where greater flexibility is required such as where more than one fund is necessary. Payments out of current receipts may be made where receipts are largely in the form of cash and the general cashier is also the custodian of the fund. In the latter method as long as total receipts are accounted for, then petty cash payments out of those receipts can also be accounted for. Of course, daily receipts either in total, or net of ordinary petty cash payments, should be deposited intact every day.

Under the imprest system a fixed sum of money is set aside to be used as a fund. The balance of the fund usually remains the same although it can be increased or decreased from time to time as the need arises. The size of the fund should be reasonable considering the volume of money paid out and the length of time elapsing between reimbursements.

Payments into the fund are charged to the petty cash account. Expenditures from the fund are charged to the proper account and credited to the petty cash account. If the fund is reimbursed for the exact amount of the expenditures then the debits and credits to the petty cash account will be equal, and the balance in the account will not vary. If it is desired to increase the fund a check in excess of expenditures is drawn. If it is desired to reduce the fund then a check for less than the amount of the expenditures is drawn, or part of the money in the fund can be deposited in the bank and credited to the petty cash account.

The fund should be replenished at least every month. Where the volume of transactions is relatively large a shorter interval is preferred in order to reduce the balance of the fund. It should be remembered that the balance of the fund represents money which cannot be used for other business purposes and should be kept to a minimum. This is especially important where there is more than one fund, such as in chain stores, branch offices or hotels. Therefore it is better to have a smaller fund and reimburse it more frequently. The system should require that the fund be replenished at the end of the last day in any accounting period or at any time a report is required in order to clear the fund of vouchers which do not represent cash on hand.

Expenditures from the fund should be supported by vouchers and should be summarized according to the accounts to be charged. The total is credited to the petty cash account. The summary may be made in either of two ways. Under the first method each petty cash voucher is entered chronologically in a columnar book. The charges are accumulated in individual columns for each account to be debited. A "total" column indicates the credit to the petty cash account. Where this method is used it is a good idea to have an extra column where reimbursement checks are entered. It is then easy to determine whether reimbursements are equal to expenditures.

Under the second method the vouchers are accumulated and no entry is made until the fund is reimbursed. At that time the vouchers are sorted according to the account to be charged and an adding machine tape is taken of the vouchers for each account. A summary tape indicates the total credit to petty cash. A journal entry is made to record the vouchers.

The first method is more cumbersome especially where the number of transactions is large, but it permits the use of prenumbering and better control against lost vouchers.

Let us see for a moment what are the essential features of a good voucher. The voucher should indicate the amount of money paid, the name of the recipient, what the payment was for, and the date of payment. It should have attached to it, evidence that value has been received for the money such as paid bills or receiving reports in the case of C.O.D. deliveries, or stamped receipts from the post office for postage stamps. It should also have the approval of a responsible party to show that the payment was authorized. A

good voucher should be made out in ink, should be prenumbered, if possible, and should have the amount written out in longhand as well as in numerals.

Where the client's organizational set-up permits it, the custodian of the petty cash fund should be a person other than the general cashier and one who has no access to the general accounting records. The custodian of the fund should not be the one who approves the payment. A person other than the custodian should examine the vouchers at least monthly for supporting evidence and authorization and should check the summary. The vouchers should then be marked or cancelled in some way. Where possible reimbursed vouchers should be filed away and the custodian of the fund should have no access to them after reimbursement. This prevents the re-use of approved vouchers. Rotation of personnel has the same advantages here as in other phases of internal control.

Auditing Petty Cash:

The petty cash audit is only a phase of the general cash audit and must be planned in advance as such. In connection with the general cash audit it is necessary to determine the amounts and location of all cash funds (petty cash, payroll, dividend, working banks, etc.), bank accounts and securities depositories. It is necessary to check the client's procedure in handling cash and the extent of the system of internal check with respect to cash. This survey will permit the auditor to lay out in advance the scope of the entire cash audit, including the audit of petty cash. Proper advance planning is quite important because of the ease with which money can be shifted from one fund to another and securities negotiated or hypothecated in order to cover shortages. While other phases of the audit may be done at almost any time, the *count* of all cash on hand and negotiable paper should be done at the same time. If this cannot be done then proper controls must be set up to see that no funds are counted more than once.

Where possible a surprise count should be made upon arrival at the client's place of business before the audit begins. If this cannot be done then the count should be made at the convenience of the client's personnel. A surprise count can then be made later if it is deemed necessary. Funds on hand at branch offices may be confirmed directly by the custodians if it is not practical to make an actual count.

In itemizing the count in the work papers the auditor should indicate the amount of currency and coin in each denomination. For each voucher in the fund he should show the date, payee, object for which drawn, and amount. There should be listed all checks cashed for accommodation purposes, "I.O.U.s", and expense and salary advances. Where necessary, approvals should be obtained. The count should be made in the presence of the fund custodian. The date and hour of the count should be noted and a signed acknowledgment should be received from the custodian when the fund is returned. Ordinarily, rolls of coin need not be counted, but packaged currency, especially where the fund is not too large, should be broken open and counted.

Old "I. O. U.s" should be transferred to loans receivable or should be written off as bad debts.

Undeposited receipts on hand must also be counted at the time of the general cash count. Shortages in the fund may have been covered by checks from current receipts and the receipts filled out by fictitious checks. Therefore, undeposited checks must be deposited and then followed up to see if they are subsequently charged back by the bank.

All vouchers between the balance sheet date and the date of the count should be checked and all transactions since the balance sheet date should be reconciled. The auditor must ascertain that the fund was cleared as of the balance sheet date by checking the dates of vouchers paid since the last reimbursement during the audit period.

On test audits a sampling of one month's transactions is made, the main purpose of which is to ascertain whether the system of internal control is being followed. Supporting data on petty cash vouchers should be examined in the same way that purchases or other expenditures are vouched. Large items should be scrutinized. Vouchers for the period should be footed and the accounts charged should be cross footed. Postings should be checked to the general ledger.

Typical Frauds and Manipulations:

Some of the more common ways of stealing petty cash funds and the way such thefts can be prevented are as follows:

1. *Fraud*—pencil entries are erased and larger amounts are inserted.

   Safeguard—use ink.

2. *Fraud*—ink or pencil numerals are changed to larger numerals, i. e. ones to fours, sevens or nines.

   Safeguard—write out numerals in longhand.

3. *Fraud*—vouchers are forged.

   Safeguard—prenumber voucher forms and require proper authorization of expenditures.

4. *Fraud*—genuine vouchers are used more than once.

   Safeguard—Date in ink, prenumber vouchers, cancel reimbursed vouchers, and file vouchers out of access of custodian.

5. *Fraud*—where voucher consists of more than one item the voucher total may be overstated.

   Safeguard—person other than custodian checks computation on the vouchers.

6. *Fraud*—footings in the petty cash book are overstated or entries in the petty cash book are made for more than the amount of the voucher.

   Safeguard—person other than custodian checks entries and footings in the petty cash book or summary.

Income Tax Problems of Hedging Transactions

By Julius B. Baer and
Abraham J. Briloff, C.P.A.

Trading in futures is the general procedure whereby manufacturers, producers, dealers and others, who are required to take a position with respect to a spot or physical commodity, are able to insure themselves against the risk of adverse fluctuations in the price of the spot commodity. This protection comes about when the producer, manufacturer or merchant hedges his spot position. Thus, a cotton textile manufacturer, who is required to take a long position in spot cotton, might insure himself against losses resulting from a decline in the market price for cotton by selling cotton futures contracts. Any fluctuation in the value of the futures contract would presumably offset the corresponding fluctuation in the value of the inventory of spot cotton owned by the manufacturer.

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The question has frequently arisen: For income tax purposes, are losses sustained in hedging transactions to be considered as ordinary deductions, or are they to be deemed capital losses? Conversely, are gains enjoyed from hedging transactions taxable as ordinary income, or as capital gain? The importance of the distinction between ordinary income or deductions and capital gains or losses is apparent from the fact that ordinary income is taxable at maximum rates of 38% for corporations and 86.45% for individuals, whereas capital gains (from assets held for more than six months) are taxable at rates not exceeding 25%. Further, ordinary deductions are considered as a reduction of gross income, whereas net capital losses are not deductable to any extent by corporations, and only to the extent of $1,000 (in any one year) by individuals. In addition, ordinary deductions may be used to increase the amount of the net operating loss carry-back or carry-over (and thus serve to reduce net income in a prior or subsequent taxable year), whereas an unused net capital loss may be carried over only for the purpose of reducing capital gains (except for the $1,000 deduction from ordinary income, allowable to individuals).

The Internal Revenue Code (Section 23(a)) allows as a deduction from gross income, "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business". Pursuant to the foregoing provision of the Code the cost of insurance has generally been allowed in the computation of net income subject to taxation. Significantly, G.C.M. 17322 (C.B.XV-2, page 151 (1936)) specifically permits as a de-

duction in the calculation of net income (rather than as a capital loss), the loss sustained by a textile manufacturer in hedging his spot position and, conversely, requires that gains enjoyed by a textile manufacturer in hedging be taxed to him as ordinary income rather than as capital gain. The conclusion reached in this General Counsel's Memorandum was based upon the determination that hedging is akin to insurance.

Recent decisions by the Tax Court of the United States and by the Circuit Courts have created serious doubt in the minds of business men and their attorneys and accountants, as to what is the nature of a hedging transaction so as to permit a deduction from gross income of losses from such transactions.

The most recent case wherein the Courts were called upon to decide upon the deductibility of a supposed hedging transaction is *Estate of Dorothy Makransky, et al. v. Commissioner of Internal Revenue*, 5 T.C. 397 (affirmed without a discussion of the issues involved herein, by the U. S. Circuit Court of Appeals for the Third Circuit, 154 F(2) 59). In that case the taxpayers were members of a partnership engaged in the manufacture of men's suits from piece goods. At the outbreak of World War II, all lines of piece goods were withdrawn from the market by the mills which then supplied the taxpayers with fabric. The partnership was an established source of supply for large retail buyers of men's clothing and *knew from past experience that their business would normally require* approximately one-half million yards of fabric for their fall, 1940, line. Inasmuch as the mills had withdrawn all their lines, the taxpayers sought to acquire raw wool, which they then intended to have spun and woven into wool cloth, suitable for their manufacturing purposes. Thereupon, on September 22, 1939, the partnership purchased, through a broker, futures contracts for wool tops to be delivered in March 1940. The partners anticipated that the wool would be of the type required for their manufacturing purposes. At the time the futures contracts were purchased, the taxpayers intended to take delivery of the wool tops and have them converted into piece goods. However, at the close of 1939, piece goods were again readily available in the market and, further, the partnership ascertained that the wool tops which would be tendered in March, 1940, would probably be of an inferior type unsuited to their clothing manufacturing purposes. Whereupon, the taxpayers sold the futures contracts (in February, 1940) at a substantial loss.

It would appear from the foregoing that it was unquestionably the intent of the taxpayers, in purchasing the wool futures contracts, to *insure themselves against the loss* which would accrue to them should they find it impossible to obtain piece goods in time to manufacture their fall, 1940, line.

The Tax Court ruled, in this case, that the transaction was not a hedge, that it was but a speculative transaction, and that the futures contracts were therefore similar to securities in the hands of a non-dealer, with the result that the loss was a short term capital loss and could not therefore be used as a deduction in determining net income nor in determining the amount of a net loss-carry over. Despite the fact that there were two strong dissenting opinions in the Tax Court decision, the Circuit Court refused to review the determination of the Tax Court, pursuant to the doctrine set forth in *Dobson v. Commissioner*, 320 U.S. 489 (1943), to the effect that a *finding of fact* by the Tax Court of the United States is not reviewable on appeal. Thus, the finding of the Tax Court in the *Makransky* case, that there was no hedge, was not subject to review by the Circuit Court.

The Tax Court considered the transaction to be speculative on the grounds that the futures purchases did not hedge against *present* (fall of 1939) *sales* of its clothing—apparently refus-

ing to consider the fact that in order to maintain its position in the men's clothing industry in the fall of 1940, taxpayers had a *present* (fall of 1939) *obligation* to assure itself of a continuous inflow of piece goods beginning in the spring of 1940.

Other recent decisions which tend to limit the scope of "hedging" operations include the following cases:

Commissioner of Internal Revenue v. Farmers and Ginners Cotton Oil Co., 120 F(2d) 772 (C.C.A.5), involved a company engaged in crushing cotton seed and selling the by-products, including crude cottonseed oil. Where the crude oil was sold at prices deemed unsatisfactory, the taxpayer bought refined oil futures contracts, which would then be sold before the delivery date. Essentially, the futures purchases were intended to offset the unsatisfactory price of crude oil (which had to be disposed of, or else the oil would become rancid) by a rise in the price of refined oil. In the taxable year, the taxpayer sustained a loss in the futures transactions. The Circuit Court of Appeals there held that the losses did not result from true hedges, inasmuch as it bought *refined* oil futures, when it had no actual commodity on hand or future commitments to be protected from price variations. The result of the foregoing decision was the holding that the losses so sustained were capital losses.

The Sixth Circuit in *Trenton Cotton Oil Co. v. Comm.*, 148 Fed. 2(d) 208, on the basis of facts similar to those involved in the *Farmers and Ginners Cotton Oil Co.* case (*supra*), stated the following in the course of its opinion holding against the taxpayer: "Before such a loss (from futures transactions) may become allowable as a business expense, it must be made to appear that a *contract has been entered into* for the sale and delivery of a product at a future date, *and that there is a counter contract* for the purchase of the same product for future delivery or one so akin to it that it affects the price of the former" (emphasis supplied).

In substance, then, the Commissioner (with the apparent approval of the Courts), has decided that a true hedge, such as would permit the deduction of losses from the transaction on the exchange as an ordinary expense, is possible only when the taxpayer had taken a spot commodity position (either long or short) *prior to or concurrently with* entering into the futures transaction. In this determination, the Commissioner is following the definition (which will be shown to be inadequate for tax purposes) of the term "hedge" as set forth in the Commodities Exchange Act, Section 4a (3) as follows:

> ". . . Sales of any commodity for future delivery on or subject to the rules of any board of trade to the extent that such sales are offset in quantity by the ownership or purchase of the same cash commodity or, conversely, purchases of any commodity for future delivery on or subject to the rules of any board of trade to the extent that such purchases are offset by sales of the same cash commodity."

That this rule is harsh is apparent from the effect of the *Makransky* case, discussed previously. That this rule makes the tax accounting for the gains or losses from hedging operations difficult and cumbersome if not impossible is apparent from the following hypothetical case: Assume that a cotton textile manufacturer has a long position of spot cotton; he hedges this position by a futures sales contract, but subsequently liquidates the spot and exchange positions at different times. Does the futures operation become speculative or does it retain its character as a true hedge, or does it become a hybrid—part hedge and part speculative? Conversely—assume that a cotton textile manufacturer has a short position in cotton futures and subsequently buys in an equal quantity of spot cotton. Does the supposedly speculative exchange position become a true hedge against the cotton inventory, or does it retain its "speculative" nature,

or once again does it partake of both types of transaction?

It would appear that the futures transactions have been too readily confused with security transactions. Undoubtedly, this confusion arises from the fact the futures contracts are bought and sold on an organized exchange, very much like securities. It is apparent, however, that this confusion is working a serious hardship on many business men (manufacturers, importers, dealers, etc.) who intend their futures trading to be as much a part of their business as their dealings in the spot commodity.

It appears, further, that relief is necessary in order to make it possible for the organized commodity exchanges to assist the business man to enjoy the maximum profit possible (or to limit his losses to the fullest extent possible) *from his trading or manufacturing operations.* The tendency of the Courts to follow the Commissioner in his determinations tending to limit the concept of a hedge, would indicate that the necessary relief may come only as a result of legislation permitting a person engaged in a trade or business to consider as ordinary income or ordinary expense the gains or losses resulting from *all futures transactions* effected through an organized exchange, *provided that the commodity so traded in is related to the other major activities of the trade or business.*

In the meantme, it is urged that business men who have engaged in transactions on a commodity exchange with the *intent to hedge,* study the results of these transactions most carefully with a view towards ascertaining whether a gain was enjoyed on such transactions. It may then be found that the gain was *reported as ordinary income* (because it was believed that the gains were the result of hedging transactions) whereas *in fact the gains were but capital gains* (by reason of the fact that the transactions were "speculative" within the purview of the Commissioner's regulations and the decisions of the Courts.) Should such a situation be found to exist in any instance, a timely claim for refund should be filed with the Commissioner. In this connection, it is well to point out that gains from the sale of capital assets held for more than six months were not subject to the corporate excess profits tax, and were subject to tax at rates not in excess of 25%. While ordinarily the statute of limitations would make it necessary to examine only the transactions for the preceding three years, the various carry-over provisions of the Internal Revenue Code make it advisable to review the transactions for the preceding five years. Upon being confronted with enough refund claims from taxpayers who sincerely believed they enjoyed ordinary income from hedging transactions but now discover that in reality they realized capital gains, it is quite possible that the Commissioner may deem it desirable to amend his regulations enlarging upon the definition of a hedging transaction, permitting the deduction of losses from commodity futures transactions as an ordinary business expense or as a reduction of gross income, where the commodity so traded in is related to the other major activities of the trade or business of the taxpayer.

Tax Accounting for Magazine Publishers

By J. K. LASSER, C.P.A.

In the determination of taxable income, magazine publishers treat many items at variance from the basic concepts generally used in other businesses. The distortions are covered in this brief summary of trade tax practices.

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1. Accounts Receivable.

The principal receivables and the principal sources of income are from subscription and newsstand sales of the publication and from advertising.

Subscription income due from mail subscribers is generally reported as income *only* when received. That follows whether the publisher reports all of it as income when received, or only the aliquot part for each year of the subscription period. Accordingly, subscriptions which are due or past due *but not yet received,* do not reflect income and are *not* considered assets.

Publishers often sell copies of the publication through the newsstands. No matter what form of contract is used, the Bureau regards these as sales by the publisher to the distributing company *at the time of delivery* of the copies. Income is created then.

Sometimes publishers do have a true consignment contract with newsstand distributing agencies. In those cases, the Bureau recognizes the fact that the asset and the sale actually arises only with the payment of cash by the distributing source. In others it might argue that reserves for returns are not deductible.(1)

Advertising is not reported as an asset or as income until the issues are *mailed* to the subscribers. Though bills may be sent to the advertisers months in advance of the delivery of the issues, only memoranda entries of them are kept. They are based on "tear sheets". When the issues are delivered to the subscribers, the advertising in them is considered income and any unpaid amounts treated as receivables.

2. Inventories.

The paper stock used for the magazine is inventoried usually at cost. The

(1) Reserves for liabilities which have become fixed are allowable as tax deductions. Actually these are not reserves at all, but true liabilities. Our decisions say, however, where the liability is contingent or indefinite, even though prudency and good accounting theory would require a reserve to be set up, most of these reserves are not deductible for income tax purposes. (See *Brown* v. *Helvering,* 291 U.S. 193). In *Readers Publishing Corporation* v. *U.S.* 40 F (2d) 145, a publishing company had a contract with a distributing company. The distributor was to be credited with all magazines which it was unable to dispose of within a certain length of time. The commissioner disallowed the reserve for returns, but allowed as deductions amounts based upon the actual number of magazines returned in the respective years at the contract price: The court sustained the commissioner saying—

> "Whether the plaintiff's books were kept on an accrual or cash basis, deductions to be allowed must be absolute in character. The reserves claimed by the plaintiff do not represent any fixed or determinable obligation but only a possible liability that would accrue, if ever, in some future year."

only addition to the purchase price is a loading charge for delivery costs.

The cost of composition or other printing costs of future issues is not inventoried unless the printer has billed for this work.[2] If these items are inventoried, they are figured at cost.

All other costs for future issues, including payments for the services of editors and others, art work, engravings and similar advance costs to prepare the issues, are generally not inventoried. These costs are usually deemed to be deductible when incurred. That is in a large measure due to the nature of the business. Costs are often incurred without specific allocation to any particular issue. Whether or not the results obtained will actually be used in an issue depends upon the then attitude of the editors and the then condition of other available items. That is not to say that inventories of these costs are never kept. Some publishers do maintain full cost records. But accountants serving the industry have generally found much worthless material in items carried forward and discourage maintenance of the asset. The Bureau has often approved that practice upon showing the worthless content of these items.

3. Deferred Costs.

Generally, all advertising and subscription promotion costs, are deducted in the year when incurred. An exception is made for certain subscription expenses when the publisher reports his subscription income on the deferred basis. Then he allocates all costs in obtaining the subscriptions and those incurred for the subscriptions themselves over the applicable subscription periods.[3] In that case only the proportionate amounts which are allocated to a later tax year are considered as deferred costs.

In effect, the publisher must choose which he shall do. If he reports prepaid subscriptions as income in the year of receipt he may treat subscription cost as an expense when incurred. If he insists upon deferring subscription income to the period served, it is reasonable that he should likewise defer his subscription costs to that period.

4. Intangible Capital Assets.

The "circulation structure" of a magazine is a valuable intangible capital asset.[4] It may be purchased or sold or its value ascertained as of March 1, 1913 for the purpose of computing gain or loss.[5]

Under the cases expenditures for *establishing* circulation and all extraordinary expenses for *increasing* the circulation are to be capitalized. When the expenditure is for the purpose of *maintaining* or *keeping up* the circulation structure already built up and established,[6] it is not a capital expenditure. It is deductible as an ordinary and necessary business expense.[7] Expenditures made to support the circulation structure are deductible expenses even though the number of subscribers is thereby *incidentally* increased.[8] When expenditures are made to secure new subscriptions, the burden is apparently upon the publisher to segregate

[2] As a matter of trade practice, printers will not bill for composition or other printing costs to be used in future issues unless the issue is mailed.

[3] I. T. 3369, 1940-1 CB 46. See also note 13, infra.

[4] *Danville Press, Inc.*, 1 B.T.A. 1171; *Herald-Despatch Co.*, 4 B.T.A. 1096; *Gardner Printing Co.*, 4 B.T.A. 37; *Reuben H. Donnelley Corp.*, 26 B.T.A. 107; *Journal of Living Pub. Corp.*, 3 T.C. 1058; *Meredith Pub. Co. v. Commissioner*, 64 F (2d) 890 (CCA 8), cert. den. 290 U. S. 646.

[5] *Elizabeth Hanavan*, T. C. Memo., Nov. 12, 1943.

[6] *Walter S. Dickey*, 14 B.T.A. 1295, affd. without discussion of this point in 56 F (2d) 917 (CCA 8); *Reuben H. Donnelley Corp.*, supra; *Journal of Living Pub. Corp.*, supra; *Meredith Publishing Co. v. Commissioner*, supra.

[7] *Public Opinion Pub. Co.*, 6 B.T.A. 1255; *Journal of Living Publishing Corp.*, supra; *Meredith Publ. Co. v. Commissioner*, supra; *Perkins Bros. Co. v. Commissioner*, 78 F (2d) 152 (CCA 8); P. S. 42-42, June 23, 1944, CCH 443, para. 6407.

[8] *Journal of Living Pub. Co.*, supra; *Perkins Bros. Co. v. Commissioner*, supra.

that portion spent to *expand* circulation from that amount spent merely to *maintain* circulation.[9] In the absence of adequate proof the entire amount may even be disallowed as a deduction.[10]

The practical approach of the Bureau today to these rules is probably this: No effort is made to capitalize costs unless there is an unusual increase in circulation. An annual rise of 10% would probably not be in that class. Nor should any rise cause capitalization, if it—

Was consistent with the growth of comparable magazines in the field; *or*

Followed the growth in the number of available persons who might read the particular magazine.[11]

No depreciation or obsolescence of the capitalized "circulation structure" is allowed as a deduction.[12] The theory is that its effective usefulness has no definite life.

5. Liabilities.

A substantial part of the publisher's expenses is often dependent upon payment by his advertisers under their advertising contracts. These include commissions due to salesmen and discounts on these contracts. These expenses are often deducted on the publisher's books when the contracts are signed or at some time prior to payment. But we may not deduct them on a tax return until the advertisers actually pay for their advertising.[13] The liabilities for these items are *contingent* upon the customers paying their accounts. Therefore, at the end of the tax year, salesmen's commissions, discounts, etc. applicable to any unpaid advertising contracts may neither be deducted as expenses for tax purposes nor accrued as liabilities. Only when the advertising contracts are paid may the deductions properly be taken and any unpaid amounts set up as liabilities on the tax return.

6. Deferred Income.

Some publishers report their subscription income on the deferred basis. They pro rate the subscription income over the subscription periods. Only the

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(9) *Journal of Living Pub. Co.*, supra; *Meredith Pub. Co.* v. *Commissioner*, supra. See P. S. 42-42, supra.

(10) See *Public Opinion Pub. Co.* v. *Jensen*, 76 F (2d) 494 (CCA 8).

(11) Practical experience today in publishing holds circulation costs to be an ordinary operating expense. Accepted practice in industry is to consider the cost as ordinary expense. In that regard, publishers are like any other businessmen. This is an ordinary sales expense.

This is a different condition than existed when circulations were more static. Today they move in great jumps. More money is available and more readers are merely solicited to get larger advertising rates. It is a relatively simple matter to attract great numbers. But numbers never establish a value. In many instances a great number of subscribers is actually a draw-back to the purchase or sale of a magazine.

Under today's operation of publications, programs to increase the list of readers are intended *only* for one purpose—to secure greater advertising revenue. The selling of a magazine to a specific number of subscribers is an essential instrument only in selling advertising. The advertiser buys the then readership.

Experienced advertisers today, and experienced publishers recognize a list can never be stable. The old and the new subscribers must be *sold continuously* by editorial satisfaction. The reader never approximates a *permanent* capital addition. Under our decisions that is an essential test when costs are capitalized.

Circulation lists of a magazine have been proven to be a very perishable item in recent years. A great number of small and large magazines have gone out of existence—even though circulation had increased very substantially just before the demise. Tests established that the demise was usually attributable to bad editorial formulas. Thus, publishers deem it sheer nonsense to attribute value to *any* circulation list today. If satisfied subscribers add value—that today is concerned only with an increase to the goodwill of a publication.

(12) *Danville Press, Inc.*, supra; *National Weeklies, Inc.* v. *Reynolds*, 43 Fed. Supp. 554 (D.C. Minn.); *National Weeklies, Inc.* v. *Commissioner*, 137 F (2d) 39 (CCA 8).

(13) *Reuben H. Donnelley Corp.*, 22 B.T.A. 175. The Court held: "A deduction may not be accrued if it is wholly uncertain whether, at the end of the year, the amount will ever have to be paid or if the amount is contingent upon later events. *Lucas* v. *American Code Co.*, 280 U.S. 445."

aliquot part is included in the income for each tax year.[14] Other publishers, though they also use the accrual method of accounting, report all of the income received from prepaid subscriptions in the year when received.

Originally, the Treasury had ruled that prepaid subscription income was income in the year of receipt even though the publisher kept his books on the accrual basis and the subscription period extended to a later tax year.[15] The reason given was that the publisher had unrestricted use and enjoyment of the payments.

In view of the fact that for years many publishers had allocated their subscription income over the subscription period and included in income only the proportionate amount for each year, a protest was filed with the Bureau. Shortly thereafter a special ruling was issued which explained that the former ruling was not intended to apply to all publishers using the accrual method. It declared that each publisher may report his subscription income under the method which he had consistently employed for years. No change was required if it clearly reflected his income.[16]

The Treasury finally embodied these views in a formal ruling and permitted publishers on the accrual basis to follow either method of reporting prepaid subscription income.[17] If a publisher has consistently used either of these two

[14] When reporting subscription income on the deferred basis, the Treasury requires that the costs expended to obtain the subscriptions and for the subscriptions themselves should be similarly allocated over the subscription period. I.T. 3369, supra.

The purchase of a magazine with a deferred subscription income account requires inclusion of the deferred items in income as the subscribers are served. Yet, the publisher is given no deduction for the cost of furnishing these issues. It is deemed a capital expenditure. *Willcuts* v. *Minnesota Tribune Co.* 103 F (2d) 947 (CCA 8), cert. den. 308 U.S. 577.

[15] G.C.M. 20021, CB 1938-1, p. 157.

[16] Letter to J. K. Lasser & Co., dated May 3, 1939, reported in P. H. 1939, para. 7.216. In GCM 20021, the Treasury ruled that prepaid subscriptions must be included as income in the year of receipt whether taxpayer was on cash or accrual basis. The ruling states that this is an instance of the "variance between an accountant's concept of income and income computed under the statute", and such income is within the general rule as to advance payments of royalties, bonuses, rent, etc., where the prepayments are received without restriction as to disposition, use, or enjoyment.

This ruling is discussed in the margin of *Clay Sewer Pipe Ass'n Inc.* v. *Comm.*, CCA-3 (1943), 139 F (2d) 130, affg. 1TC 529, where such income is treated as included within the general rule of advance payments. In *Clay Sewer Pipe* the organization received funds from manufacturers to promote the sale of clay sewer pipe for the industry. It sought to deduct excess of receipts as a reserve for future expenses as outlined in the agreement with the manufacturers. It claimed the money received from members was a prepayment for services and it was under an obligation to use the money only in the manner provided in the contract with its subscribers. The argument failed.

"The test determining the taxability of the payment is whether they were received under a claim of right and without restriction as to their disposition. . . . The taxpayer does not contend, and with apparent good reason, (inserting here the marginal note referred to above) that mere receipt by a taxpayer on an accrual basis, of money as a prepayment for services to be rendered in future years prevents taxation, as income in the year received. . . . The Supreme Court in the *North American Oil* case clearly stated, earnings which otherwise meet the test as taxable, remain taxable although the recipient claims he is not entitled to retain them and may be adjudged liable to return their equivalent. . . . This result was obtained even where the taxpayer was rquired to set up a fund to repay the money at a future date. *Cleveland R. Co.* v. *Comm.*, 36 F (2d) 347, certiorari denied."

Subsequently, in I.T. 3369, 1940—1CB 46, the Treasury ruled that where a publisher has, *over a period of years*, consistently reported an aliquot part of the subscription income for each year of the subscription period, allocating expenses on the same basis, he *may continue* to file his returns on such basis, and his net income for the past years will not be redetermined on the basis of treating all receipts as income in year of receipt.

It is argued that this routine is a concession by the Bureau. It is an exception to the general rule as to advance payments. Therefore, it is argued that a *new* publisher does not have a right of election but *must* report advance subscription income in the year of receipt. The exception would be a case where the Bureau gave authority to prorate the income on application to it.

[17] I.T. 3369, supra.

methods[18] he will not be required to change to the other method. He may continue to file his tax returns under the method employed and his net income for prior years will not be redetermined under the other method.

When advertising income is prepaid, the income is deferred until the year when the issues are delivered to the subscribers. This practice has been established in the trade for many years.[19]

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(18) In the case of *Globe-Gazette Printing Co.*, 16 B.T.A. 161 (acquiesced in by the Commissioner), the Court permitted a publisher to report his advertising income on the accrual basis, even though his salaries and other expenses and his subscription income were kept on the cash basis. The Court recognized the fact that reporting advertising income on the accrual basis was the customary practice amongst publishers.

(19) *Brown* v. *Helvering*, supra, is authority also for the proposition that a taxpayer who receives a payment in advance of performance, where there are no restrictions on the use of the payment, has received income whether on cash or accrual basis. It is immaterial that he might later have to return all or part of it. This unfortunate doctrine has had its most frequent application in the case of advance rentals. for example, *South Dade Farms* v. *Comm.* 138 F (2d) 818, CCA-5, (1943). The doctrine has not been limited to rents, but has been extended broadly to cover generally all advance payments where there is unrestricted use or employment thereof. In *C. H. Mead Coal Co.*, 31 BTA 190, advance royalties under a coal lease were held taxable in full to a taxpayer on the accrual basis. See also *South Tacoma Motor Company* 3 TC 411; *Your Health Club, Inc.* 4 TC 385. In *E. B. Elliott Co.*, 45 BTA 82, the taxpayer on the accrual basis received advance payments on contracts for outdoor advertising. Taxpayer had unrestricted use of the prepayments but refunds would be made in the event the site was lost. Unearned income was deferred. The court held that the advance payments were income in the year of receipt, since the use of the money was unrestricted. The court stated that "the payments are in the nature of advance rentals". It is sometimes contended that advance rentals is an exception to the accrual method and regular accounting method, and therefore does not extend to prepaid magazine advertising.

The author feels that a valid argument can be submitted that the deferral of advertising income, being an established practice amongst publishers, should follow the same rule as is applied to prepaid subscription income. There is no fundamental distinction between prepayments of subscription and advertising. (Many arguments can be offered on that issue: the agreement between the parties, the understanding that services must be rendered in the future or the amount must be repaid, the established practice, etc. These apply to both items.) It would clearly be inconsistent and illogical on the part of the Treasury to treat both items differently. In both cases the publisher should be given the election to treat the income on the "cash" or deferred basis. At most, if he elects to treat the prepaid advertising on the deferred basis, he should also be required to defer over the same period the costs in obtaining the advertising. Perhaps, the same evolution will be necessary—sufficient protests and proofs of established practice amongst publishers—before the Treasury will issue a formal ruling for the deferral of advertising, comparable to its rule for subscription income. Its only concern should be the consistency of the practice, and the clear reflection of income. The *Globe-Gazette Printing Co.* case acknowledges the practice amongst publishers to report advertising income on the accrual basis even though they maintain a hybrid system of accounts. Their advertising is ordinarily kept on the accrual basis despite the fact that their subscription accounts, etc. may be kept on the cash basis. The Court stated that the company was, nevertheless, on the accrual basis.

Tax Accounting for Farms

By Leslie Mills, C.P.A.

Definition of Farm

In connection with gross income, the Regulations define "farm" and "farmer" as follows:

> "As herein used the term "farm" embraces the farm in the ordinarily accepted sense, and includes stock, dairy, poultry, fruit and truck farms; also plantations, ranches, and all land used for farming operations. All individuals, partnerships, or corporations that cultivate, operate, or manage farms for gain or profit, either as owners or tenants, are designated as farmers. A person cultivating or operating a farm for recreation or pleasure, the result of which is a continual loss from year to year, is not regarded as a farmer."

This discussion does not cover the so called "gentleman" or "hobby" farmers referred to in the last sentence of the above definition.

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During World War II, Mr. Mills attained the rank of Commander in the United States Naval Reserve (Supply Corps) and served as a member of the Price Adjustment Boards of both the War and Navy Departments.

Mr. Mills has served on the Institute's Committee on Federal Taxation, and is now Vice-Chairman of the Society's Committee on Federal Taxation and a member of its Committee on State Taxation.

Inventories

Farmers reporting on the accrual basis, and therefore using inventories in determination of taxable income, may value inventories by one of three methods: (a) cost, (b) the lower of cost or market, or (c) at "farm price". Livestock raisers may also use the "unit livestock method".

The Regulations[1] recognize that farming and livestock raising are industries in which the usual rules for computation of cost of production are inapplicable, and therefore allows approximations on a reasonable basis, in conformity with established trade practice. Cost of purchased items of inventory must include transportation costs to the farm, while cost of produce of livestock raised will comprise actual cost of supplies consumed, and a reasonable allocation of indirect expenses. Cost should not include anything for labor of the individual farmer or of his family.

The "farm price" method of inventory valuation[1] consists of valuing at market price less estimated cost of marketing.

The "unit-livestock-price" method[1] provides for valuation of livestock, by classes, at a standard unit price. The standard prices should be based on reasonable estimates of normal production costs. Once adopted and approved, the classifications and unit valuations cannot be changed without approval by the Commissioner of Internal Revenue. They must be applied to all livestock raised, whether inventory or not. Purchased livestock should be valued at cost.

Farmers may include, in inventory for tax purposes, all livestock whether purchased, or raised for sale, draft, breeding, or dairy purposes. However despite this permissive classification

[1] This and subsequent footnote references are to be found at the end of the article.

(and attendant use of inventory valuation methods) livestock raised or acquired for draft, breeding or dairy purposes is "property used in the trade or business" for purposes of taxation of gain or loss on sale. Therefore computation of gain or loss must give recognition to depreciation allowed or allowable,[2] and also the provisions of Sec. 117(j) I.R.C.[3] will apply. This rule applies both to farmers reporting on the accrual basis (and therefore using inventories) and to farmers using the cash receipts and disbursements basis, although of course in the latter case there will be a basis of zero. The Treasury Department has ruled[3] that permission to include such livestock in inventory "for convenience of accounting" does not render it "property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year" so as to deprive the taxpayer of the benefits of Sec. 117(a) and 117(j) I.R.C.

The ruling referred to above[3] also states that the sale of animals culled from the breeding herd as feeder or slaughter animals in the regular course of business is not to be treated as the sale of a capital asset. The Treasury Department has recognized that in many cases it is impractical to determine accurately the number of animals sold from the breeding herd, as contrasted with those sold in the ordinary course of culling, and has issued a ruling[4] providing a prima facie test for the guidance of livestock raisers. This ruling provides that determination of whether an animal sold was "held for breeding purposes" or was a "cull" shall be made from the point of view of the seller, and in no case shall be affected by the purpose to which the animal is put by the purchaser.

The "crop basis" is available to farmers producing a crop which takes more than one year from the time of planting to the time of harvesting and sale.[2] Its use requires permission of the Commissioner. In effect, it defers deduction of expenses and taxation of receipts until the dispositon of the crop is substantially completed, thus being similar to the completed contract basis of tax accounting. If a farmer on the crop basis received insurance on loss of crops for several years, it has been held that he must treat the indemnity payment as receipts from the crop of each year to the extent that the indemnity was allocated to such crops.[5]

Crops are not ordinarily included in inventory prior to maturity; however if land is purchased with growing crops thereon, a value should be assigned to the crops, to be recovered in computation of gain or loss on their sales.[6,7]

Gain or loss on trading in commodity futures by a farmer in the course of his business constitute ordinary income, not capital gain or loss.[13]

Real Estate and Equipment

It has been noted above that while for accounting convenience inventory may include such items as work animals this classification does not change their character for tax purposes as "property used in the trade or business".

The farmhouse, as the farmer's home, is not depreciable for tax purposes, and therefore is a capital asset.

Considerable difficulty has been experienced in the question of whether farmers should capitalize or expense currently such items as preparatory expenditures in the development of farms, orchards, and ranches prior to attainment of the productive stage when saleable crops are obtained. For a long time it was generally felt that farmers had the option of capitalizing or expensing such items. The Bureau has recently ruled[8] that betterments (such as cost of clearing, grading, planting trees, building irrigation systems) must be capitalized. Expenses which are ordinary and necessary by their nature (such as upkeep, cultivation, spraying) may be capitalized or expensed, at the option of the taxpayer. The ruling[8] provided that the treatment of preparatory expenses on taxpayer's return for years beginning prior to July 1, 1946, would not be disturbed. However a later ruling[9] provided that unless the

taxpayer had, in returns filed prior to June 20, 1946, treated development costs as ordinary and necessary business expenses, he must capitalize such expenditures, even though the taxable year begins prior to July 1, 1946. This special ruling[9] stated that it was not intended to allow deduction of capital expenditures incurred with respect to a project commenced in a taxable year with respect to which no returns were filed prior to June 20, 1946, the date of issuance of the mimeograph.[8]

Another recent ruling[10] calls attention to the fact that the basis of land and buildings and equipment should not include any portion of the purchase price properly allocable to growing crops on the farm at the time of acquisition.

Preparatory costs in connection with bringing crops to maturity, such as expenditures on an orchard, may, if capitalized, be recovered by depreciation over the average life of the trees[11].

Payments for acreage reduction under the Agricultural Adjustment Act constitute taxable income[12]; as do payments or grants received from the Secretary of Agriculture under the Soil Conservation and Domestic Allotment Act[17].

Liabilities

By specific statutory provision[14] farmers may elect to treat loans to farmers by the Commodity Credit Corporation, secured by pledge of the commodities, as income of the year in which received. In effect, the farmer is considered to have sold the crop for the amount of the loan. This election is binding for future years when made, and change requires approval of the Commissioner. It has been held that even on the cash basis the loan is taxable income in the year it was approved and the check mailed, even though the check was not received until the following year[15].

If on sale of the pledged commodity, the farmer receives more than the loan, that receipt is taxable income for the year received. No loss will result from sale of the commodity for less than the amount of the loan unless the taxpayer is required to satisfy the deficiency[16].

Returns

A special return, Form 1040F, is provided for individual farmers. This return is optional for accrual basis farmers, and mandatory for cash basis farmers. It is not a complete return, and is to be filed in conjunction with Form 1040.

By special statutory provision[18] the declaration of estimated tax required by Sec. 58 I.R.C. may be made by farmers any time on or before the 15th day of the first month following the taxable year concerned.

FOOTNOTES

References to section numbers are to the Internal Revenue Code, or to Regulations 111.

1 Sec. 29.22 (c) (6), as amended by TD 5423-12/15/44; also, mim. R.A. No. 1399, 12/16/44.
2 Section 29.22 (a) (7).
3 IT 3666, 1944 CB page 270.
4 IT 3712, 1945 CB page 176.
5 *Kahuku Plantation Co.*, 13 BTA 292.
6 O.D. 714, 3 CB 49.
7 *Parker*, 13 BTA 1239.
8 Mim. 6030, June 30, 1946.
9 Special Ruling, Commissioner of Internal Revenue, July 31, 1946.
10 IT 3815, 1946-18-12389.
11 OD 797, 1 CB 130.
12 IT 2767, X111-1 CB35.
13 *Ben Grote*, 41 BTA 247.
14 Sec. 123, I.R.C.
15 *Sloper*, 41 BTA 746.
16 Sec. 29.123 (1), (2).
17 IT 2992 XV-2 CB 75, IT 3379, 1940-1 CB 16.
18 Sec. 60, I.R.C.

PROFESSIONAL COMMENT

By Emanuel Saxe, C.P.A.

Problems of a Medium-Sized Public Accounting Office

Ralph B. Mayo, senior partner of the Denver accounting firm of Ralph B. Mayo & Company, and a past president of the Colorado Society of C.P.A.'s, considers the more important administrative problems of the middle-sized accounting firm in a paper appearing in The Journal of Accountancy for December, 1946.

Under the heading of *Office Records,* Mr. Mayo discusses, first, the basis of accounting. Despite the conservatism inherent in the use of the cash basis for income tax purposes, the author concludes that the accrual basis is to be preferred in both small and large offices. Second, the need for time reports is stressed, and it is suggested that they be kept on a decimal basis, accurate to the nearest .25 (¼) hour. Third, an excellent suggestion is made that accountants should get away from the computation of bills upon a strict time-consumed basis. Mr. Mayo urges that the "results accomplished, importance and responsibility of the work, and even ability to pay be given their proper weight." Lastly, under this topic, the author suggests that cost records be maintained to show the fees produced by each man, as well as the cost of each engagement, thus making both principals and staff members cost conscious and, thereby, more efficient.

In discussing the problems of *Personnel,* Mr. Mayo rightfully observes that "no accounting office is any better than the quality of its personnel," and he maintains that "accounting can maintain its place only by encouraging higher educational courses for all members of the staff." With respect to the administration of an on-the-job-training program, a note of caution is sounded, to the effect that members of the profession should consciously obesrve the letter and the spirit of the law, and refrain from using the plan as a means of reducing salary costs. Next, the important subject of staff compensation receives consideration. Various plans of compensation and related "courtesies" (i. e., year-end bonuses, vacations and sick leave with pay, etc.) are analyzed from the viewpoint of creating in staff members a sense of "belonging to" and loyalty to the organization. Lastly, Mr. Mayo discusses under this heading the problem of "how to give young men who are growing in stature and ability adequate opportunities for development." The suggestion is made to them to bear in mind the possibilities of eventually becoming a principal, a supervisor, a special departmental executive, or a manager of a branch office.

The last topic considered by Mr. Mayo is *Management of Time.* Various suggestions are offered to overcome the seasonal demand of our work and to assure continuity of employment, such as the adoption of fiscal years by clients, the performance of preliminary or interim work in slack periods during the year, and the judicious use of overtime during the peak season. To aid in the control of unproductive time, the author advocates that the cost of all such time be summarized in separate expense accounts, and intimates that the accountant may be surprised at the result.

Mr. Mayo's article, though short, is an important contribution to the thinking in this field.

* * *

An Accounting Course for Technical and Non-Technical Students

Following the recent appearance of an editorial in the columns of The Jour-

nal of Accountancy suggesting the establishment of a separate basic course in accounting for nontechnical students, Messrs. Daniel Lipsky and Elmer R. Young, of the accounting faculty of Brooklyn College, have prepared a paper (appearing in The Journal of Accountancy for December, 1946) outlining the work of a first year course in accounting whose content, in their opinion, has been so rearranged as to make it fit the needs of both technical and nontechnical students.

The work of the first semester, as thus rearranged, is designed by the authors for the nontechnical students; the work in the second semester, they say, completes the content of the customary first-year course for the technical student who plans to continue his studies in the field.

This commentator disagrees strenuously with the fundamental premise of the authors, namely, that instruction in accounting for one semester is a sufficient time allotment for nontechnical students who plan to go ahead in such fields as law, finance, engineering, and economics. The authors themselves, have serious qualms on the point, and answer it by stating (p. 500) that "the perhaps limited understanding acquired in this one semester of work *should* become enhanced by varied applications in the specialized courses in the student's field of major interest" (emphasis supplied). In my opinion, the contrary is true; it is not so enhanced. The aversion of the average lawyer to matters involving figures is notorious. No serious student of finance would dare to interrupt his instruction in accounting at the end of one semester. Economics is not yet fully developed as a quantitative science; rather it is more concerned with economic theories, motives, and processes than with measurements. Statistical analysis is a very distant cousin, indeed, to accounting measurement and control! And while there is some nearer kinship evident in the ties existing between accounting and engineering, due to the fact that both fields are developed upon a mathematical basis, experience indicates that engineers who expect to have any contact with business, generally take at least two full courses in accounting by way of academic preparation—one in accounting principles and one in cost accounting.

In my opinion, all that can be taught (or learned) in one semester of accounting is a smattering of information, which is likely to be far more dangerous than none at all. It is my firm belief that the minimum unit of basic instruction in accounting should be one year; further, that nontechnical students may profitably pursue a differentiated course.

* * *

Trade Union Accounting Problems

Siemon L. Hamburger, the General Auditor of the International Ladies' Garment Workers' Union, discusses this subject in the December, 1946, issue of The Accounting Forum, and outlines the accounting structure and procedures employed by his organization to record its financial transactions.

Mr. Hamburger begins by explaining the accounting problems involving individual members, starting with the payment of the required initiation fee and continued by payment of current dues. The functions of all records involved in the process, such as the receipt, the dues book and the ledger card, are explained and integrated.

Next, the author considers the activities of the District Councils, which represent groups of local unions rather than the individual members thereof, and indicates the treatment of their accounting problems. Where, as is usually the case in large cities, it is desirable to provide unified representation for all the members of several local unions representing the various crafts within a given industry in that locale, a Joint Council (or Joint Board) is organized. Mr. Hamburger also includes this situation in his paper.

The accounting problems of the union's General Office are then considered and they are usually worked out, says the author, upon the same basis as is applied to the records of local unions The periodic reports received by the General Office from its locals and councils, including those reflecting membership statistics, financial data, etc., are tabulated both by function and geographical unit, and are then analyzed, summarized, and interpreted for the use of executive and convention groups.

Mr. Hamburger concludes his paper with a discussion of the auditing problems of trade unions. He believes that the audit function is best performed for them by internal auditors, and outlines his views on the background and training of the union auditor. He notes the special auditing problems inherent in the trade union auditing process, but does not discuss them specifically in terms of an audit program.

It is too bad that Mr. Hamburger did not expand this interesting outline of the subject into a more complete presentation thereof. It is to be hoped that he will soon be persuaded to record more fully his wealth of background and experience in this field.

* * *

Accounting in the Shoe Manufacturing Industry

Louis E. Zraick, who is now a cost accountant with OPA's regional office in New York, was somewhat surprised, following a recent investigation, to discover a paucity of written information upon the subject of accounting in the shoe manufacturing industry. He thereupon set himself the task of preparing a paper to remedy this shortcoming, with a threefold purpose, viz.,

"(1) to familiarize the public accountant with the peculiarities of the shoe manufacturing industry and the terminology in use.

(2) to present a chart of accounts that will facilitate the preparation not only of financial statements, but of cost information as well. The system of accounts should also aid in budgetary and cost control.

(3) to comment on many of the incorrect accounting practices prevalent today, and to offer criticism of a constructive nature."

Mr. Zraick believes that accountants should become more "cost" conscious than ever before, particularly in "an industry as large and diversified as shoe manufacturing, (where) less than 20 per cent of the shoe companies in existence today have cost accounting systems in use."

The complete article appears in the Journal of Accountancy for December, 1946.

* * *

Investigation of Internal Control

The December, 1946, issue of The Journal of Accountancy includes an article under the foregoing title, written by J. Harold Stewart, of the Boston accounting firm of Stewart, Watts & Bollong. Mr. Stewart reminds the profession of the importance of currently appraising the effectiveness of the internal control system, not only from the viewpoint of management's desire to prevent fraud and eliminate error, but also from the professional standpoint of meeting what has become an accepted auditing standard by reason of the statement in the present approved short-form accountant's certificate, to the effect that the auditor "has reviewed the system of internal control and the accounting procedures of the company."

Several methods of accomplishing a satisfactory review of the internal control system are discussed. Two case studies are presented illustrating the importance of vigilence in guarding against the infiltration of deviations into a satisfactory accounting system. The author's concluding admonition to direct our attention once more to internal control in its broadest aspects, may well bear constant repetition.

New York State Tax Clinic

Conducted by BENJAMIN HARROW, C.P.A.

WITH this issue The New York Certified Public Accountant inaugurates a new department devoted to a discussion of problems of State and local taxes. All members are invited to send in their questions and problems, particularly those which are being currently considered or which have been recently decided, and which the membership-at-large would find of interest.

Revised Regulations for Article 9A

The State Tax Commission has released a revision of the Regulations covering the franchise tax on business corporations. In 1944, when article 9A was radically revised the law provided for the issuance of Regulations. These were first issued in April, 1945. Since 1944 the legislature has made some changes in the law notably those affecting consolidated returns and the Commission itself has issued some rulings, particularly with respect to modifications of the allocation formula. These are all embodied in the revised regulations. Members are advised to familiarize themselves with the new regulations.

December Meeting on State Taxation

At the December meeting of the Society the members were given an opportunity to hear and to meet the new President of the State Tax Commission, Hon. Spencer E. Bates, a man who for many years has had the leading responsibility for the administration of the franchise tax law of our State. We wish him continued success in the position he has attained. Present also at the meeting was Benjamin B. Berinstein, Manhatan District Supervisor who is in full charge of New York City office. Those who know him are aware that he is one of the ablest men in the Department. Taxpayers can be assured of a respectful and sympathetic hearing of their problems. George P. Klein, Director and Deputy Tax Commissioner rounded out the group of speakers. He now occupies the position formerly held by Roy H. Palmer. We shall miss the familiar letters bearing his signature that "plagued" taxpayers for additional information. Such letters will now bear the signature of Morton V. Valley, an able attorney who is now the Senior Tax Administrative Supervisor.

Real Estate Returns on a Fiscal Year Basis

For many years accountants had sought vainly for permission to file franchise tax returns for real estate corporations on a fiscal year basis. Our own State Tax Committee even went so far as to prepare a bill which was passed by the 1945 legislature to accomplish this, only to have it vetoed by the Governor at the request of the State Tax Commission. Our members will be glad to learn that the Commission has now met our problem by permitting the filing of the income statement on a fiscal year basis but still requiring the submission of the asset and liabilities statement on a calendar year basis. For real estate corporations this should not present any difficult problems.

Applications for Revision

A taxpayer may apply for a revision of its franchise tax (Sec. 214.1) both under Article 9 and 9A. Such application must be made within two years after the original assessment of the tax or within one year after any reassessment. The State Tax Commission provides Form 7CT for this purpose and it is advisable for taxpayers to make a formal application for revision on such form. In the past, informal applications for revision were accepted but in view of the legislative provision now prescribing a limitation of time for filing

such applications, the Commission has been obliged to be more insistent on a formal application. The date of original assessment is not the date of filing the return. It is the date of the notice of the amount of tax payable as computed by the State Tax Commission, which notice is sent to the taxpayer by the Commission after it has examined the report filed by the taxpayer.

Franchise Tax Returns For Corporations on a Fiscal Year Basis

The franchise tax return for business corporations is generally due to be filed each year on or before May 15. However, in the case of corporations with fiscal years ending on the last day of January, February, March, April, May and June, the return is due within four months after the close of the fiscal year. This provision is the result of an amendment to Section 211.1 of the law made by the 1946 legislature. Prior to this amendment the provision with respect to fiscal year corporations was not applicable to those corporations whose fiscal years ended on the last day of January or February.

Due Date of Final Payments for 1946 Franchise Tax Returns

One half of the franchise tax under Article 9A is due and payable with the filing of the report. The balance is due on notice from the State Tax Commission *but in no event later than January 15* following the due date of the report even if the taxpayer receives no notice. Failure to pay the balance by January 15 results in the imposition of a penalty of 5% on the unpaid tax plus interest at the rate of one per cent a month. In 1946 Commissioner Chapman waived the delinquency penalties and interest on payments due January 15 because of what he called an apparent misunderstanding and misapprehension that the January installment was not due until the corporation received a bill from the Commission. Taxpayers are cautioned not to be delinquent on the payment due in 1947.

Final Franchise Tax Due on Corporations that Dissolve

Under the new franchise tax law it is no longer possible for a corporation to avoid the payment of a franchise tax based on its income or other appropriate basis for the year of its dissolution. A domestic corporation that dissolves or a foreign corporation that ceases to do business in the state is required to file a final report and pay its franchise tax on the day it ceases to exercise its franchise. It is taxed for the privilege of having exercised its franchise or done business from the beginning of its fiscal year to the date of dissolution. Such a corporation may, of course, obtain an extension of time for filing its return or paying the tax.

Distinction Between Regular Place of Business and Permanent Place or Business

The right of a taxpayer to allocate its income within and without the state depends upon whether the taxpayer has a regular place of business outside the state. This must be other than a statutory place. The regulations define a regular place of business as any bona fide office, factory, warehouse, or other space which is regularly occupied and used by the corporation in carrying on its business through at least one of its regular employees in attendance. However the taxpayer may allocate its income if as a regular course of business it stores property in a public warehouse or its own warehouse until it ships the merchandise to customers. Such a warehouse is considered a regular place of business. Again, if as a regular course of business, merchandise is delivered to an independent contractor to be converted, processed, or finished and the merchandise remains in the possession of the independent contractor until shipped to customers, the plant of the independent contractor is considered a regular place of business.

To allocate sales within and without New York however the taxpayer must have a permanent or continuous place

of business that is an office, factory, warehouse or other space outside New York which is continuously maintained, occupied and used by the taxpayer in carrying on its business through one or more of its employees regularly in attendance. Property stored in a public warehouse, or in the possession of an independent contractor under the circumstances mentioned in defining a regular place of business would not be deemed to be at a permanent place of business. This may sound like hair splitting but the Commission follows the distinction and if applicable will within these definitions allow an allocation under the tangible property factor for merchandise at a regular place of business and yet will not permit the allocation under the sales factor unless the regular place of business can also be considered a permanent place of business.

Subsidiary Income & Capital

Under new article 9A subsidiary income is not taxed to a parent company. The law does not define subsidiary income, although subsidiary capital is defined generally as investments in the stock of subsidiaries and any indebtedness of the subsidiary on which interest is not claimed and deducted by the subsidiary in determining its own franchise tax under article 9A. The law provides that income, gains and losses from subsidiary capital are to be excluded from entire net income. An interesting situation arises where a parent company owning 100% of the stock of a subsidiary derives income in the form of royalties from its subsidiary on valuable patents that it owns. Would royalties be deemed to be income from subsidiary capital? If so, the parent company would not be subject to tax on its royalty income. The Commission however considers royalties as business income limiting its concept of subsidiary income to dividends and interest. If the parent company is a foreign corporation with only a statutory office outside of New York it would be subject to tax as a business corporation on all the royalty income without any allocation. This results in a hardship that apparently was not foreseen when Article 9A was revised. Perhaps the situation will have to be cured by incorporating in the law a definition of a subsidiary income broad enough to include royalty income from patents used by a subsidiary.

Federal Income Taxes—In 1929, In 1940, In 1945

This table shows how income taxpayers in representative brackets have fared since 1929.

	1929	1940		1945	
Net Income	Tax	Tax	Increase Over 1929	Tax	Increase Over 1929
$ 3,000	$ 0	$ 31	Infinite	$ 475	Infinite
5,000	6	110	1,854%	975	17,218%
7,000	13	233	1,692%	1,555	11,862%
10,000	53	528	896%	2,585	4,777%
12,000	105	783	646%	3,365	3,105%
15,000	225	1,258	459%	4,695	1,987%
25,000	862	3,843	346%	10,295	1,094%
100,000	14,870	52,704	254%	69,435	367%

From the *New York Sun* (p. 62), January 6, 1947.

COMMITTEE ACTIVITIES

Statement By Committee on Professional Conduct

It has come to the attention of the Society's Committee on Professional Conduct that some members have been circularized by organizations which offer for sale lists of new businesses, the price of such lists being dependent upon the frequency of issuance. These communications are apt to delude the unwary member into thinking that all he need do to increase his practice is to subscribe to the lists offered and to use them in turn to circularize the names included in such lists.

This seems an appropriate time to caution the members of the Society against adopting methods such as this to increase their practice. Rule 9 of the Society's Rules of Professional Conduct, as recently amended, states that

> "A member shall not directly or indirectly solicit clients by circular, by advertisements, or by personal communication or interview not warranted by existing personal relations. However, a member may furnish service to those who request it."

It should be self-evident that circularization by a member of concerns, the names of which are included in purchased lists, would constitute a violation of the rule above quoted and subject the offending member to disciplinary action.

HAROLD B. SIMPSON
Chairman, Committee on Professional Conduct

CORRECTION, PLEASE!

A mischievous gremlin got loose last month and played havoc with some of the citations appearing in the text of Mr. Norris Darrell's remarks, reported in "*Ten Current Tax Problems*", pages 27 to 29.

All references therein to Section 112(g)(6) should have been to Section 112(b)(6) of the Code.

Mr. Darrell also calls attention to the fact that with reference to the last item in his discussion, a decision was rendered by the Tax Court since the date of this meeting (*Margaret R. Phipps*, 8 T.C. #21, January 28, 1947), which holds that deficits as well as accumulated earnings and profits of subsidiaries liquidated under I.R.C. 112(b)(6) go forward to the parent company.

BOOK REVIEWS

Financial Statements, Form, Analysis and Interpretation,

by Ralph L. Kennedy. Chicago, Ill., RICHARD D. IRWIN, INC., 1946. 559 pages. $4.50.

The author of a text must keep in mind the position of the subject he is covering in the usual curriculum of the type of school that teaches the material with which he is dealing. The author of a text in accounting must keep in mind the usual curriculum of schools of business. Most schools of business require two years of general accounting before the problem of analysis of financial statements is given sufficient attention to warrant classifying it as a separate course. The author of a book on that subject should therefore assume that his students have the knowledge which they would normally acquire in those two years.

It is of course true that a certain amount of review of the particular background required for any course is desirable, but this should not be overdone. Mr. Kennedy's book overdoes it. Four chapters totaling 99 pages are devoted to "Introduction", "Balance Sheet", "Profit and Loss Statement" and "Statements of Surplus and of Capital". These chapters attempt to introduce the students to material which should have appeared in the two prior years' work. Possibly because of this extensive coverage, the author has produced a group of chapters which have a very choppy feeling when read. Had the four chapters been consolidated into one, and had less attention been given to detail, a more readable portion of the book would probably have resulted.

In this same section, the author gives numerous balance sheets and profit and loss statements, any one of which could have formed the basis for a very considerable discussion, which the author does not give them. They could very well have been added later in the book as illustrations of the material which the author discusses in the body of the text. They are useless where they now stand.

The body of the text, consisting of chapters 5 through 17 (Chapter 17 is included in Part II, but properly belongs in the body of the text) is very well written and does an admirable job of covering the analysis of financial statements. The author is constantly conscious, and makes the student conscious, of the fact that ratios, percentages and other analyses of statements by themselves can only be jumping-off points for an analysis of the status of a business. Thus, on page 211 he states that "it is necessary to emphasize repeatedly that ratios and percentages are only starting points in analyses." On page 151, we have the statement that "it must always be remembered that the trend or other ratios are valuable only to the extent that they give clues to favorable or unfavorable tendencies and cause further investigations." Possibly the author overemphasizes this note of caution, but experience with students indicates that they are too much inclined to take a series of percentages and draw all sorts of conclusions from them without giving attention to the fact that there may be some peculiarity in the business in question or in its operations or its status which invalidates those conclusions, even though those percentages might normally be valid in supporting the conclusions drawn by the reader.

The author gives over his last eight chapters, constituting 167 pages of text material, to a discussion of the financial statements of specific organizations. The discussion is excellent and shows

the author to have a very fine background in the subject matter. However, the choice of organizations whose statements are examined seems somewhat inappropriate. Two chapters each are devoted to "Statements of Air Carriers", "Statements of Railroads", "Statements of Public Utilities" and "Statements of Commercial Banks". There are no chapters devoted to the statements of the more usual merchandising, manufacturing or service entities. It would seem more appropriate first to discuss in detail these last named, and then, possibly as additional matter, to add something with reference to such unusual organizations as those which the author does discuss. The analysis of statements of such organizations could more appropriately be given in a course devoted to a general study of such organizations, or possibly as an addendum or appendix to such a general course as the author undoubtedly had in mind when he wrote the book. The author himself states in his discussion of statements of air carriers that "the same technique and statistical units used in analyzing commercial financial statements cannot be used without modification in analyzing air carrier financial statements. An entirely different type of asset is used by air carriers; also a different type of service is performed."

The chief defect in this text is the omission of several chapters analyzing the financial statements of more or less ordinary businesses, the sort of things that an accountant might expect to run into with some fair amount of regularity in his public practice. The inclusion of excess material consisting of the introductory and the concluding chapters is not too serious a defect since the instructor in the course can always omit them, and will still find sufficient material for a very fine course in financial statement analysis.

RALPH G. LEDLEY

New York, N. Y.

Business Budgeting and Control,

by J. Brooks Heckert. New York, THE RONALD PRESS COMPANY, 1946. Pages: ix + 546. $5.00.

This book makes a strong bid for dual acceptance as a college text and as a handbook for the budget minded business and industrial executive. Considering the technical nature of the subject matter, Professor Heckert has been unusually successful in presenting a most readable treatise on the preparation of the complete business budget and its invocation as an instrument of executive control. While forms and formulas are liberally sprinkled throughout the 27 chapters, the book is predominately a well expanded discussion of the ways and means for developing and applying budgetary precision to the financial operations of all departments of both a manufacturing and mercantile business.

For those who may be interested in the pedagogical merits of the book, the 60 fully captioned and chapter classified problems on the final 72 pages, appear to be worthy of classroom experimentation. Professor Heckert's time estimate of from 30 minutes to 10 hours appears to be more than liberal, but this will depend upon whether graduate or undergraduate students are involved and the extent of prior academic preparation. This reviewer believes that a minimum of 2 years of general accounting, one year of statistics, one year of fundamental mathematics, plus a thorough grounding in standard costs, constitutes the basic prerequisites that are implied by the level of presentation in this text.

While many of the problems submitted in this book are lengthy and involved, there are none that are intended to provide a complete budget picture, even in summary form. The only continuity of the problems is the basic theory as is progressively developed in the chapters. Contrary to the usual practice of the budget executive, the student of budget procedures usu-

ally prefers to have schedules and illustrative solutions which he may audit as a test of his understanding of the theory and outlines. Professor Heckert has not seen fit to provide a term problem that is comprehensive of all budget phases.

The development of standard costs and the preparation of the many budgetary yardsticks suggests to the accounting-wise executive one and the same thing. To the non-specializing accountant, standard costs deal exclusively with factory costs, whereas the budget specialist considers "standards" as having a much broader application. Professor Heckert has gone further than any of his predecessors insofar as distribution cost standards. This reviewer has the definite impression that this area of budget preparation is a favorite with Professor Heckert, and through sheer zeal of enthusiasm he has developed this field disproportionately to the comparable subdivisions of production and finance.

In a book of this nature the professional reader would normally expect eventually to be provided with citations and extracts from specific industries. The soundness and clarity of a particular budgetary procedure falls somewhat flat when the reader is left to conjecture as to just what types of businesses employ the recommended plans. Reference is made to the chain store, the chemical manufacturer, the wholesale grocer and the retail drug business, but the illustrative observations and comments are indirect (publication of the Metropolitan Life Insurance Company, is cited) and have limited application to the comprehensive budget problem.

While the need for variation analysis is discussed, outlined and, in many instances, supported by form media, the relative emphasis upon this phase of budget implementation is allowed to slacken off undesirably, in the opinion of this reviewer. Many authors in the field of budgets are satisfied with an "over and under standard" type of analysis of budget variation. Professor Heckert does point out the need for identifying functionally the variation analysis with such factors as "waste", "unskilled labor", "foreman inefficiency", "breakdowns", etc. The specific identification of the responsibility for budget variation provides the channel by which the budget is able to pay for itself by pointing out uneconomic yet controllable variations.

The chapter on the financial budget leaves many minor problems unillustrated. The budget schedule of receipts and disbursements does not indicate how to handle staggered collections with estimated allowances for discounts. The planned use of short term bank credit, the dividend policy, the potentiality of capital retrenchment and the long run capital expenditures program, are all omitted from consideration in this chapter.

The concluding appraisal is that this book should receive wide acceptance as a text for a graduate course in budget procedures for accounting majors. It offers a great deal more of workable material in academic form, than is elsewhere available at the present time. As a handbook for the budget executive, the appeal is not so strong. However this book should find its way to the shelf of many executives who can profit by making comparisons with other materials in the same field.

LAWRENCE W. SHERRITT
The School of Business
and Civic Administration
The City College of New York

Advanced Accounting (Fourth Edition).

by Roy B. Kester. New York, THE RONALD PRESS COMPANY, 1946. x + 796 pages. $5.00.

Once again, Professor Kester has subjected his standard work on Advanced Accounting to a thorough revision, with particular care "to meet the author's conception of one phase of the educational needs of the profes-

sion," which he believes should be developed through single-purpose professional schools of accountancy rather than through multi-purpose schools of business. Dr. Kester believes that "a three-year course in basic accounting principles should provide the core of the curriculum," and this volume is offered as a text for the work of the second year in such a curricular pattern. The present edition continues the recognition and treatment of the basic elements inherent in the preparation of of financial and operating statements as contained in the earlier editions, but attempts a more fundamental and critical treatment. Each item in the corporate balance sheet is considered from the viewpoint of the propriety of (1) the included elements; (2) the measurement thereof (the previous edition used the term "valuation"); and (3) the manner of its presentation.

The basic format of the book has been changed: Coincident with an increase in the page size, the type line has been lengthened, and there are more lines to the page. As a result, there is more reading matter in the 680 pages of text of the present edition than in the 846 pages of the 1933 (third) edition.

A new problem section of 93 pages has been added to provide practice material for the student. Its arrangement conforms to that of the text, thus affording the instructor the opportunity easily to correlate the assignments of text and problems.

Some entirely new materials appear in this edition: thus, Chapter 2, entitled "Measurement in Accounting," makes its appearance following preliminary publication in substantially the same form in our October, 1944, issue. Also, the subject of "Relevant Events After Balance Sheet Date" (presently being studied by the Institute's Committee on Accounting Procedure), discussed on page 26; the topic, "The Footnote as a Technique of Form", appearing on page 53; the section, "Measurement of Income Operations", beginning on page 82; chapter 20 on "Capital Surplus"; the discussions of accounting principles insofar as they pertain to the balance sheet (chapter 1) and to the profit and loss statement (chapter 21); the discussion of consolidated working papers in Chapter 29;—all attest to the thoroughness of the revision.

The chapters on "Branch Accounting" (28 and 29) and those on "Liquidation and Estate Accounting" (34, 35 and 36), appearing in the previous edition, have been eliminated from this one. Other chapters have been rearranged and renumbered.

Some comments are offered for the author's consideration upon the occasion of a future revision: This reviewer does not concur in the following statement appearing on page 123, in the chapter on Cash and Marketable Securities: "The amount to be incorporated in the . . . balance sheet is that determined by the lower-of-cost-or-market formula applied to *each* item in the portfolio" (emphasis supplied). The pamphlet entitled "Examination of Financial Statements by Independent Public Accountants," promulgated by the American Institute of Accountants in 1936, states the rule of accepted practice to require the application of this formula to portfolio totals (Securities (12), p. 16).

In the discussion on "Sources of Dividend Declarations" (pages 525-6) there is reference to the Wisconsin statute permitting dividends declared out of surplus arising from appreciation, but no mention of the leading New York case of *Randall v. Bailey et al.*, 288 New York 280 (1942) on the same subject.

Nor will all accountants agree with Dr. Kester's statement on page 534 to the effect that extraordinary gains and losses, not of a regularly recurring nature, should be handled through the surplus account.

All in all, Dr. Kester's Fourth Edition of his "Advanced Accounting" continues to maintain its preeminent

position as one of the outstanding volumes in the literature of our profession and to provide practitioners and students, alike, with a lucid and authoritative presentation of the subject.

EMANUEL SAXE

How to Take Physical Inventory,

by Richard F. Neuschel and Harry T. Johnson. New York, McGRAW-HILL BOOK COMPANY, INC., 1946. vii + 159 pages. $2.00.

The authors of this book were given the assignment to plan and direct the taking of a year-end physical inventory. They searched the recent literature of the profession to ascertain the extent of the published knowledge and experience of others on the subject. So little was found to exist that they determined to fill the need by preparing this book, which is divided into two parts: (1) seven chapters delineating the procedures to be followed in preparing for the physical inventory; and (2) an appendix of 95 pages, consisting of a manual of inventory instructions successfully used by the authors to take a large and complex physical inventory.

The importance of the planning phase of the inventory problem obtains from the fact that the inventory-taking period must necessarily be very short, the services of large number of employees who generally have had no previous inventory experience must be utilized, and the results must be complete and accurate despite the involvement of many different departments in the process. The proper planning includes "designing the forms to be used for recording the identification and count; determining the other supplies required, planning the inventory-taking procedures in detail, developing the inventory-taking organization structure, selecting and training the personnel, and arranging the materials to be inventoried so that the counting process will be facilitated."

The planning process must also include the preparation of a program designed to reduce the quantities to be counted to a minimum and to arrange them in such a way as to facilitate the count. The instructions must then set forth detailed procedures for "identification of the items to be inventoried, measuring the quantity of each item, recording the identification and quantity, checking the recorded data, and distributing and controlling the forms on which the inventory data are recorded."

Of course, all of the inventory plans, policies, and procedures should be reduced to a manual of written instruction, to be utilized as the basis for training the inventory organization while, at the same time, serving to integrate and clarify the plans. All tags, forms, and other special supplies must be prepared in advance.

Next, the inventory personnel must be selected, indoctrinated and trained to insure an interested, efficient, and accurate inventory organization.

Lastly, the summarization of the inventory involves the transcription of the data appearing on the original tags to summary schedules, the pricing and extending of the quantity figures, and the recapitulation of these data according to the scheme of inventory control accounts prescribed by the company's accounting system.

The foregoing is a summary of the topics covered by the authors in this manual. They have provided a first-rate guide to the inventory process, which is both practical and concise. All persons who have inventory responsibilities and problems should read this book.

Accounting in Community Chests,

by The Accounting Committee of Community Chests & Councils, Inc. New York, COMMUNITY CHESTS & COUNCILS, INC., 1945. 54 pages. Single copies: $2 to members; $3 to non-members.

The introduction states that "This accounting manual has been designed

as a usable reference book for community chest volunteers and professional staff. It has come as a result of urgent and repeated requests for an easily understood and practicable guide as to how chest accounting can be done properly in light of the chest's responsible position of stewardship to the contributing public and to its participating agencies."

The manual outlines the need for and the nature of an accounting system, with particular reference to the requirements of Community Chest accounting. Minimum safeguards to protect against error and fraud are explained and stressed. A uniform chart of accounts is presented, which will serve as a basis for the comparison of central and common service costs for participating agencies. A brief bibliography, eight exhibits of specimen books and forms, and a subject index complete the compilation.

Classified Cost Accounting Bibliography,

compiled by A. L. Prickett. (Indiana Business Studies: Study No. 29) THE SCHOOL OF BUSINESS, INDIANA UNIVERSITY, Bloomington, Ind., 1946. 463 pages (lithoprinted).

This very comprehensive bibliography of cost accounting publications embraces the period from 1890 to July, 1944. It indexes the included items under eighteen classification groups alphabetically by authors. By reference to supplementary code columns, the reader may also ascertain the month, year, and type of publication, as well as the identity of the publisher. It appears to be an exceedingly useful volume.

Uniform Accounting Manual for the Plastics Industry,

New York, SOCIETY OF THE PLASTICS INDUSTRY, INC., 1946. 71 pages. Price to non-members, $5.00.

In order to establish accurate and more uniform financial statements, costs, and estimates in the Plastics Industry, the Executive Accounting Committee of the industry has prepared this comprehensive Manual, covering the following subjects:

- Financial Statements
- Classification or Chart of Ledger Accounts
- Sales Analyses
- Accounting for Manufacturing Cost
- Accounting for General Expenses
- Formula for Costs and Estimates on Individual Articles
- Supplements and Appendixes on Specific Accounts
- Suggested Forms and Procedures

Additional supplementary material now being developed by the Committee (including standard costs, bases of liquidating factory overhead, etc.) will be sent to holders of the Manual upon completion.

Montgomery's Federal Taxes—Estates, Trusts and Gifts (1946-47),

by Robert H. Montgomery and James O. Wynn. THE RONALD PRESS COMPANY, New York, 1946. x + 990 pages. $10.

1,000 pages of "interpretation and advice founded in the experience of an organization of accountants and lawyers who have handled tax problems for thousands" aptly describes this current edition of Montgomery's annual work in this field!

As usual, Col. Montgomery begins his work with a breezy preface which includes his perennial plea for a nonpartisan revision of our whole tax structure. The body of the text is then developed according to the following topical outline:

Part I—Methods of Estate Distribution

Chapter

1. Planning the Distribution of an Estate

Part II—The Income Tax on Decedents, Estates and Trusts

Included in this edition is a consideration of the new Treasury Department regulations under the *Clifford* and *Hallock* cases and, of course, the important rulings and court decisions newly promulgated during the past year. The preliminary section on planning for estate and income tax reduction continues to be a most valuable guide in avoiding the intricate difficulties inherent in the process.

In this reviewer's opinion, this work is an indispensable part of the library of all practitioners in the field of fiduciary taxation.

Lasser's Business Tax Guide (1947),

by J. K. Lasser. SIMON AND SCHUSTER, New York, 1947. ix + 218 pages. $2.00.

J. K. Lasser, C.P.A., and author of YOUR INCOME TAX, has prepared this excellent manual for use as a guide and check list by business men and their advisers who desire a complete reference to the alternatives, options, and mechanics for business (federal) tax reduction, as well as to the potential pitfalls inherent in situations involving unsettled tax problems. The book represents the distillation of the thinking and practice of the author and his partners during the past twenty-five years, and covers all commonly encountered varieties of business organizations and business problems. It is so designed as to provide a rapid approach to any topic, whether from the viewpoint of the nature of the specific problem, the type of business organization, or the number of the Treasury Regulation or Code Section involved.

It should be another best seller in the Lasser series!

OFFICIAL DECISIONS *and* RELEASES

SECURITIES AND EXCHANGE COMMISSION

Philadelphia

HOLDING COMPANY ACT OF 1935
Release No. 7017

In the Matter of
KANSAS CITY POWER & LIGHT COMPANY
File No. 70-1391
(Public Utility Holding Company Act of 1935)

Extracts from the FINDINGS AND OPINION OF THE COMMISSION

Kansas City Power & Light Company ("Kansas City"), a subsidiary of Continental Gas & Electric Corporation ("Continental"), in turn a subsidiary of The United Light and Railways Company, a registered holding company, has filed applications and declarations and amendments thereto pursuant to Sections 6 (b) and 12 (c) of the Public Utility Holding Company Act of 1935 and Rules U-42 and U-50 promulgated thereunder relating principally to the refunding and refinancing of Kansas City's outstanding bonds and preferred stock by the issuance of new bonds, serial notes and preferred stock.

After appropriate notice a public hearing was held. Having considered the record, the Commission makes the following findings:

* * *

Proposed Transactions

The transactions proposed in the filing may be summarized as follows:

Kansas City proposes to amend its Articles of Incorporation (1) to reclassify 210,000 authorized but unissued shares of First Preferred Stock into 100,000 shares of Cumulative Preferred Stock and 110,000 shares of Common Stock; (2) to reclassify 100,000 shares of authorized but unissued Participating Preferred Stock into 100,000 shares of Cumulative Preferred Stock; and (3) to provide that all shares of its Preferred Stock acquired through redemption or otherwise be cancelled.

Kansas City also proposes to issue and sell, pursuant to the competitive bidding requirements of Rule U-50, $36,000,000 principal amount of First Mortgage Bonds, due 1976, and 100,000 shares of Cumulative Preferred Stock, par value $100 per share. The interest rate on the new bonds . . . and the price to be received by the company . . . are to be determined by competitive bidding. The dividend rate on the new preferred stock . . . and the price to be paid to the company . . . are also to be determined by competitive bidding.

In addition, Kansas City proposes to issue and sell to a group of commercial banks $4,000,000 principal amount of 10-year Serial Notes, maturing at the rate of $400,000 principal amount on December 1 of each year beginning with December 1, 1947. The notes maturing on or before December 1, 1951 ($2,000,000 principal amount) will bear an interest rate of 2% per annum, and the notes maturing after December 1, 1951 ($2,000,000 principal amount), will bear an interest rate of 2¼% per annum.

Kansas City proposes to use the proceeds of the issue and sale of the bonds, notes and preferred stock to redeem its outstanding First Mortgage Bonds, 3¾% Series, due 1966, in the principal amount of $38,000,000 at the redemption price of 110% of the prinicpal amount thereof plus accrued interest and to redeem its outstanding 40,000 shares of $6 First Preferred Stock, Series "B", without par value, at the redemption price of $115 per share plus accrued dividends. A portion of such proceeds will also be applied to the payment of the expenses of refinancing, and the remaining balance (estimated at $3,560,000) will be added to working capital.

The proposal by Kansas City includes a commitment by Continental to purchase on or before March 1, 1947 additional shares of common stock from Kansas City for a cash consideration of $3,500,000. The purchase and sale of such common stock will be the subject matter of a separate filing. The cash so received together with other available company funds will be used during the next three years for the construction of needed facilities. The company estimates that approximately $20,000,000 may be expended for additions to utility plant by the end of the calendar year 1949 and on the basis of its present program does not anticipate that any additional financing will be required.

The proposed transactions, with the exception of the issue and sale of additional common stock, have been expressly approved by the Public Service Commission of the State of Missouri, and the State Corporation Commission of the State of Kansas has issued a memorandum opinion indicating its approval generally, but reserving express approval until the results of competitive bidding are known.

* * *

Accounting Treatment

The company intends (a) to amortize through income, over the life of the new bonds, the excess of the premiums received from the sale of the new bonds, if any, over the expenses of issuance thereof, or, in case such expenses shall exceed such premiums, to amortize such excess expense through income over the life of the new bonds, (b) to reduce the redemption premiums, balance of expenses and duplicate interest to be incurred in connection with the redemption of the outstanding bonds, less the unamortized net premium applicable to such bonds, by an amount equivalent to the reduction in the Federal income taxes (estimated at $680,392) which will result from the refunding, (c) to amortize through income, over a period estimated at three years, the remainder of such premiums and expenses (estimated at $1,099,505) in an amount of $390,000 per year, approximately equal to the net annual savings in interest charges, (d) to write off to earned surplus the $630,000 of redemption premiums and expenses to be incurred in connection with the redemption of the outstanding preferred stock and the $12,953 of capital stock expense applicable to the presently outstanding preferred stock, (e) to credit to "Premium on Preferred Shares" the premiums, if any, received from the sale of the new Preferred Stock, and (f) to charge to "Capital Stock Expense" the estimated $50,000 of expense of issuing the new Preferred Stock.

* * *

Conclusion—(As summarized in the headnote): Proposed issuance and sale, by subsidiary of a registered holding company, of its bonds, serial notes, and preferred stock, *found*, subject to reservation of jurisdiction over matters to be determined when competitive bidding has been concluded and with respect to fees and commissions, to satisfy the standards of Sections 6(a) and 7.

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